December 1957

THE CANADIAN CHARTERED ACCOUNTANT

THE CANADIAN INSTITUTE OF CHARTERED ACCOUNTANTS

Verification of the Existence of Assets

Depreciation and Taxes - Theory and Practice

rganization of a Credit Department in a Company

The Practice of Management Advisory Services

Canadian Higher Education Under Strain

ACCOUNTING RESEARCH: The Amsterdam Conference

ADMINISTRATIVE ACCOUNTING: Own, "Lease-Back" or Rent?

TAX REVIEW: More of the Nothings

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THE CANADIAN
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EDITORIAL

ARTICLES

DEPARTMENTS

MONTHLY FEATURES

The Canadian Chartered Accountant, December 1957. Published monthly by the Canadian Institute of Chartered Accountants. Chairman, Editorial Board, C. K. MacGillivray, F.C.A.; Editor, Renny Englebert; Asst. Editor, Jean Vale. Advertising Representative, E. L. Vetter, Editorial and business office: 69 Bloor street east, Toronto 5. Subscription rates: $6 a year; 60 cents a copy. Printed by General Printers Limited and mailed at Oshawa, Ontario. Authorized as second class mail by the Post Office, Department, Ottawa. Opinions expressed are not necessarily endorsed by the Canadian Institute.

IN THIS ISSUE

M. C. LUKE (page 537)

Under whose jurisdiction in the corporate structure should the responsibility for credit be placed? Opinions differ and while, according to M. C. Luke, credit can and does operate successfully within both the sales and financial departments, the author feels that "logic will eventually promote the establishment of credit management on a completely autonomous basis". In a thought-provoking and informative article "The Organization of a Credit Department in a Company", the author demonstrates what credit is capable of doing in relation to the marketing of goods and as an effective tool in the management of a company's assets. He goes on to suggest that because the drive for sales and the urge for conservation in finance are such powerful motivating forces, credit should not be directly exposed to their control.

Mr. Luke is general credit manager of Canadian Industries Limited, Montreal, a position he has held since 1945. Before joining C.I.L. in 1936, he served for 14 years in various capacities with Canadian International Paper Company.

J. A. de LALANNE, C.A. (page 529)

The theme at one of the business sessions of the 7th International Congress of Accountants held in Amsterdam in September was "The Verification of the Existence of Assets". The rapporteur and author of a paper on this subject was James A. de Lalanne, who analyzes here the key questions concerning the methods and procedures which should be adopted by the auditor to satisfy himself of the existence of various types of assets. The author sums up his case by saying that personal inspection is generally the surest evidence of existence and that the time frequency and coverage of any inspection will depend on the nature and size of the undertaking, the extent and effectiveness of the internal control and other pertinent factors.

Mr. de Lalanne is president of the Canadian Institute of Chartered Accountants and a partner in the firm of McDonald, Currie & Co. in Montreal. He is president of Pirelli Cables, Conduits Limited, a director of several other companies, and also serves on the Montreal Advisory Board, Chartered Trust Company. He is a past president of the Institute of Chartered Accountants of Quebec.

J. J. MACDONELL, F.C.A. (page 511)

There are signs that the whole complex position of practising chartered accountants and their relationship to management consulting is beginning to take top rank place at conferences and in discussions between members of the profession. James J. Macdonell believes this to be a subject of special importance and in "The Professional Practice of Management Advisory Services", he presents a critical evaluation of the profession's response to the mounting demand for management services. He concludes with a discussion on the type of service that a management advisory group can give as well as an examination of what the next decade or so will mean to the profession through identifying itself more firmly in the public mind as management consultants.

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Mr. Macdonell is a partner of Price Waterhouse & Company, Montreal and has been in charge of management advisory services for the firm in Canada since 1945, following eight years with Canadian Industries Limited. He was admitted to the Institute of Chartered Accountants of Quebec in 1937, and became a member of the Ontario Institute in 1950, and was named a Fellow in 1956. He has served on a number of C.I.C.A. and Quebec Institute committees and is a past chairman of the Editorial Board of *The Canadian Chartered Accountant*. He is well known for his contributions to this journal and for other articles on subjects related to management organization and administrative practices.

E. W. NETTEN, C.A. (page 543)

Of all the bulletins which have been issued by the Committee on Accounting and Auditing Research of the Canadian Institute, one of the most controversial has been Bulletin No. 10, dealing with depreciation, capital cost allowances, and income taxes. Other bulletins merely re-affirmed or clarified established accounting principles whereas this bulletin may well have established a new principle. In "Depreciation and Taxes – Theory and Practice", Edward W. Netten examines the problem of tax reduction and then proceeds to analyze five of the methods which have been suggested for handling it, all of which have support in some quarters.

We are pleased to welcome back Mr. Netten to our pages. Readers may recall that he was a prizewinner in the 1955-56 article writing competition ("Accountancy of the Future", CCA Dec. 1956). He received his certificate in chartered account-

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ancy in 1953 and from 1951-56 was with McDonald, Currie & Co., Montreal. He recently joined the Management Advisory Services group of Price Waterhouse & Co. in Montreal.

G. L. COURT, C.A. (page 522)

Between now and 1967, senior educational institutions in this country must raise almost $300,000,000 for new plant and equipment – or about as much as their existing facilities are worth. Between now and 1980, they must raise at least $1,000,000,000, or even more, if they are to turn out anything like the number of graduates Canada needs. That is just capital cost. Operating cost, which in 1956 was less than $50,000,000, may be ten times that high 25 years from now. The need for funds is sudden and immediate and in "Canadian Higher Education Under Strain", George L. Court shows why such an alarming situation has arisen and suggests what must be done by both the government and private industry to finance the expansion of Canadian institutions during the next 20 years.

Mr. Court is comptroller of the University of Toronto, a position he has held for the past two years. He has been associated with the university in various capacities since 1939. He was admitted to membership in the Institute of Chartered Accountants of Ontario in 1939 and is also a member of NOMA, Toronto Chapter.

EDITORIAL (page 509)

A highlight of the year, now drawing to a close, was the 7th International Congress of Accountants held in Amsterdam last September. Members of the profession came from all parts of the world to discuss prob-

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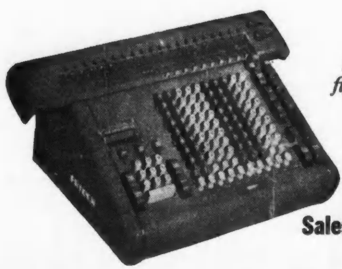

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lems of practice and this month we are publishing a full account of the proceedings by L. G. Macpherson, F.C.A. together with a paper on "The Verification of the Existence of Assets" which was delivered by C.I.C.A. president, J. A. de Lalanne. In subsequent issues we plan to publish commentaries on some of the more important papers which were presented at the congress.

The Editors asked W. L. McDonald, F.C.A., a Canadian Institute official delegate, to contribute this month's editorial on "What the International Congress Has Meant to Us". The author also attended the congress held in London in 1952 and draws on his experience as a delegate to both when he says that accountants should be prepared to attend such international affairs and gives his reasons why they should be supported.

Mr. McDonald is a partner in Price Waterhouse & Company, Toronto and a past president of the Institute of Chartered Accountants of Ontario. He has served on many committees including the C.I.C.A. Committee on Accounting and Auditing Research. He was admitted as a Fellow of the Institute of Chartered Accountants of Ontario in 1947.

FORTHCOMING FEATURES

KEY MEASUREMENT OF THE CANADIAN ECONOMY
R. B. Crozier

TECHNIQUES OF INVENTORY OBSERVATION
N. S. Vallance
W. P. Wallace

INTEREST RATES ARE AWAY DOWN!
W. C. Stuart

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NOTES AND COMMENTS

T4 Supplementary Forms

The Taxation Division of the Department of National Revenue has advised that certain changes will be made this year in the method of distributing forms T4 Supplementary to individual accountants and accounting firms. Last year, employers were asked to advise the name of their accountant. However, there was no identification on the shipment to the accountant so the accountant did not know for which of his clients that particular supply was intended, and it is believed that a great deal of confusion and duplication of supplies resulted.

This year, the employer will be informed on the notice received from the Taxation Division not to complete the related portion of the requisition card if an arrangement has been made for an outside accountant to prepare his T4 report. Thus the Department is leaving it to the individual accountant and accounting firms to procure their own requirements of T4 Supplementary forms by writing or calling the District Directors — Taxation. However, should the T4 fail to be filed on time owing to a misunderstanding between the employer and the outside accountant, the general instruction on the requisition form will not be accepted as a valid reason for not imposing the late filing penalty upon the employer or for imposing it upon the accountant instead of the employer.

The Department also advises that form T4 Supplementary will be available this year in both unit sets and continuous form. The form has been increased in size from a slip 8½" x 1½" to a slip 8" x 3", in the case of the unit sets, and 8½" x 3", in the case of the continuous. The continuous form has the feature of parts 1 and 2 being glued together in a left hand side stub whereby, after removing the carbon, these two parts can be broken into individual controlled duplicate sets for distribution purposes.

Supply of the 1957 T4 forms will be available in December of this year at the District Taxation Offices and it is expected that supplies of the 1957 Income Tax forms T1 Short and T1 General will be available upon request at any Post Office or District Taxation Office on and after January 2, 1958. Form T1 Short will again be printed in sets, each comprising two copies of Form T1 Short and one copy of the Employee's Income Tax Guide.

Accounting firms are asked to avoid wasting forms by ordering quantities sufficient only to meet their requirements.

Guests from India

As part of an extensive six-week tour to study the prevailing accounting practices and thought in the U.S.A. and Canada, three members of the Indian Institute of Chartered Accountants were guests of the C.I.C.A. in Toronto recently.

S. P. Chopra, past president of the

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Indian Institute, E. V. Srinivasan, secretary of the Institute and S. N. Desai were met on arrival by John A. Wilson, member of the C.I.C.A. executive, and taken on a sightseeing tour of the city. The following day, their itinerary included visits to practising firms that offered management advisory services. Calls were also made on the Provincial Auditor's office, the offices of the Canadian and Ontario Institutes and a number of industrial concerns.

President Visits Chile

James A. de Lalanne, president of the C.I.C.A., represented the Canadian Institute at the 4th Inter-American Conference on Accounting held in Santiago, Chile from November 15 to 23. The conference provided accountants from all parts of the Western Hemisphere with an opportunity to discuss their common professional problems.

A Loss to the Profession

With the deepest regret we have learned of the untimely death of Professor Wilfred Berman, C.A. of Dalhousie University following an attack of influenza. Professor Berman organized and conducted a number of courses for chartered accountancy students in conjunction with the Nova Scotia Institute, and his death is a grievous loss to the profession.

Exams amid the Coral

The first Canadian chartered accountancy examinations ever conducted outside the country were held this fall in Hamilton, Bermuda when seven students wrote the uniform examination of the Provincial Institutes of Chartered Accountants. Previously, it had been necessary for Bermudians to travel to Canada to sit their examinations, but this year the Nova Scotia Institute decided that the relatively large number of candidates warranted establishing an examination centre in Bermuda. Supervisor of the examination was George Finlay of Halifax, immediate past president of the Institute and a member of its Education and Examinations Committee.

To Aid the Profession

A little more than a year ago the Committee on Accounting and Auditing Research published suggested certificate forms for use in the confirmation of inventories and liabilities (C.C.A. Sept./56). Since that time the C.I.C.A. office has received many requests to produce and sell these forms in quantity. It is happy to announce they are now available in both English and French. The price of either form is $1.00 for 50 or $2.00 for 100. Orders may be placed by writing to The Canadian Institute of Chartered Accountants, 69 Bloor Street East, Toronto 5. For the present only non-imprinted forms may be obtained.

Tax Foundation Meet

A record number of 570 registered at the annual conference of the Canadian Tax Foundation in Toronto on November 11 and 12.

American Institute Elections

Alvin R. Jennings, a partner in the New York office of Lybrand, Ross Bros. & Montgomery, was elected president of the American Institute of Certified Public Accountants at its annual meeting in New Orleans at the end of October. Mr. Jennings is co-author of the latest edition of "Montgomery's Auditing" and has written numerous technical articles.

Vice-presidents elected were Donald J. Bevis of Michigan; Roy C. Comer of Washington; Louis H. Pilie of Louisiana and John M. Stoy of Washington, D.C. John B. Inglis

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of New York City was elected treasurer.

U. S. Research Plan

A plan for a new research organization to further the development of generally accepted accounting principles has been outlined to the American Institute of Certified Public Accountants at its recent annual conference. The proposed organization would consist of a five or six-man staff of experts able to contribute the points of view of industry and the academic world as well as that of practising accountants. Their conclusions would be submitted for approval by the Council of the American Institute. If accepted, the resulting bulletins would be binding on members of the AICPA in the application of "generally accepted accounting principles".

Corporate Cash Dividend Restrictions in U.S.

The number of U.S. corporations disclosing restrictions on the amount of cash dividends which may be paid to stockholders continues to increase according to the 11th edition of "Accounting Trends and Technique", just published by the American Institute of Certified Public Accountants.

The survey of 600 annual reports shows that approximately 61% of the companies studied were limited to a maximum cash dividend payout by the terms of outside indebtedness and credit agreements. This represents an increase of 9% from 1951, when only 313 of the companies disclosed dividend restrictions.

First Electronic Reader

The first production model of the newly invented Solartron Electronic Reading Automaton has been purchased by The Boots Pure Drug Company, well-known British pharmaceutical chemists. It will be installed at Boots' head office in Nottingham where its task will be to read the printed sales record produced on rolls by the cash registers in the firm's 1300 branches. This installation will be the first of its kind in the world. The reading machine will convert the printed figures into electrical impulses and feed them to an electronic accumulator, which will then print out the totals required. Its reading speed is 200 to 300 characters per second.

Season's Greetings

In full measure we wish all our readers a right Merry Christmas and a new year of peace and prosperity.

TWO NEW PUBLICATIONS

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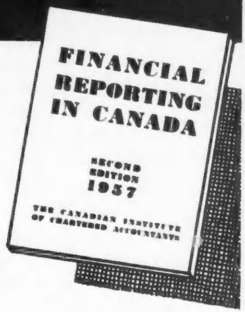

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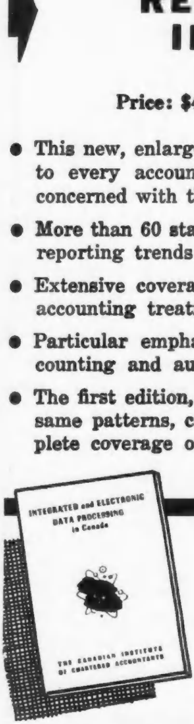
Order form at foot of opposite page



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Order form at foot of opposite page

Editorial

WHAT THE INTERNATIONAL CONGRESS HAS MEANT TO US

THE SEVENTH International Congress of Accountants was held in the Concertgebouw, Amsterdam, from September 9 to 13. Thousands of Canadian accountants who were not present probably have very little conception of its nature and purpose. What happened at Amsterdam, however, is of importance to accountants all over the world and will undoubtedly have an indirect effect on accounting practice everywhere.

Accounting documents whose fairness is attested to by members of our profession are an important method of communication between countries concerning information relating to financial matters. Where such accounting documents are based on principles of accounting that are reasonably uniform throughout the world, there will be a satisfactory international language for the communication of information in commercial fields. Any improvement in communication leads to better understanding, and this, in turn, should result in better international relationships.

The proceedings of the congress made it clear also that ethics and character are indispensable to the successful practice of accounting and any assessment in this regard can best be summed up in the words of Sir Thomas Robson, a delegate from the United Kingdom and a Fellow of the Institute of Chartered Accountants of Ontario:

> "Our participation here shows the world wide nature of our profession and our belief that the principles which should govern it are universal. Accountants need the basic qualities of character and competence, but they need also the benefits which come from contacts with other accountants, from the impact of mind on mind and the discussion of common problems. The profession itself in every country needs a like impact; it can obtain this by participation in congresses such as this, by the despatch of its members to work in other countries and by the contact which it maintains with accountants from abroad who work within its own country."

The thoughtful and inspiring address of Prince Bernhard, delivered in perfect English, also deserves consideration. In his address of welcome to the delegates, he said:

> "Important decisions are very often based, wholly or partly, on the opinions expressed by accountants. Those decisions are mostly related to economic and financial matters which domi-

nate for a large part the relations between individuals and communities. In promoting fairness and honesty in all kinds of financial statements and presentations, accountants make a valuable contribution to the founding of human relations on principles of truth and justice. You will only be able to reach your goal if you succeed in feeling yourselves members of a fraternity which is based on mutual understanding and appreciation, which should promote and strengthen feelings of friendship and goodwill."

It is words like these that strengthen the sense of purpose to which the profession is dedicated and forge stronger bonds between professional accountants of many countries.

The world is shrinking in size and it behooves the Canadian accountant to support in every way the development of accounting and auditing standards which will have acceptance throughout the world. There is, as yet, no formal world organization which promotes such an aim, but there is an opportunity to meet accountants at international congresses. The profession should be prepared to attend such congresses and to support the adoption of accounting and auditing procedures and methods which will form an acceptable basis for the accounting documents which can be such a useful aid in international communication of financial information.

A NEW EDITOR FOR ADMINISTRATIVE ACCOUNTING

The Administrative Accounting Department in *The Canadian Chartered Accountant* was first introduced in August 1955 and is an important feature of the magazine for those accountants who are in industry. Its first editor was Kenneth Place, C.A., who relinquished the task last October. His successor is John W. Crowe, C.A., of Canadian Industries Limited, Montreal, who, as consolidated accounting supervisor, is responsible for the financial reporting procedures, financial budgets and related matters for C.I.L. and its subsidiaries.

The need for this department is actuated partly by the substantial number of members in the profession who are in industry, which is now approximately 3,280 out of a total of 7,444 members. The department will cover a broad list of subjects of interest to accountants in industry whose growing function it is to be concerned with all the facets of management at all its levels.

Mr. Crowe is well qualified for the task. He graduated in Arts and Economics at the University of Manitoba and received the gold medal for the highest standing in Economics. After the war, he joined Canadian Industries Limited as income tax supervisor and later transferred to Defense Industries Limited as chief accountant. He subsequently took the position of works accountant at C.I.L.'s Edmonton polythene plant in order to set up accounting systems and related activities. He has held his present position since 1955.

The Professional Practice of Management Advisory Services

JAMES J. MACDONELL

A FEW MONTHS AGO the Board of Control of a large Canadian city sought management consulting services for a thorough-going survey of the city's administrative organization and practices. A number of firms, both Canadian and American, were interested in this engagement, and nine or ten placed proposals before the Board. Among these were several Canadian firms of chartered accountants. None of the latter was seriously considered. The grounds: they were chartered accountants, not management consultants. But the president of the company that received the assignment is a chartered accountant and several chartered accountants are included in its board of directors. The company, however, designates itself as "Management Consultants" and the chartered accountants associated with it as directors or in an executive capacity do not publicly identify themselves as C.A.'s.

In a recent article *The Financial Post* estimated that there are some 30 firms active in the field of management consulting in this country, and named the four largest. Chartered accountants are identified in the firm names of three of these four. Each firm is a limited company, but its executives and officers who are members of our Institutes do not identify themselves as C.A.'s. This same article completely overlooked the fact that there are a number of firms of chartered accountants with well-established departments maintaining permanent staffs of management consultants. In some instances these departments are as large as, and indeed even larger than, several of the four firms mentioned in *The Financial Post's* article, and have successfully completed hundreds of management consulting engagements for Canadian companies of every size and type.

The purpose of recounting these two instances is to point up the serious confusion, if not the complete ignorance, which exists in the minds of the public regarding the role the practising chartered accountant has been, and is, playing in this important field of professional service.

Were the members of the Board of Control of the city in question, and the editors of *The Financial Post,* to be blamed for not recognizing chartered accountants as management

A paper delivered at the C.I.C.A. annual conference, Saskatoon, Aug. 20, 1957

consultants? Or is the attitude and thinking of our own profession and its individual members at fault? Mostly the latter, it would seem. It is true that as professional men and members of one of the three great "business professions", our concepts of integrity and professional ethics prevent us from advertising our services and blatantly promoting our wares. On the other hand, is it not decidedly in the interests of ourselves as a profession, and in the public interest also, including members of boards of control of Canadian cities and the editors of great financial newspapers, that there should be a more general awareness of the nature and extent of the professional services which we, as chartered accountants, are well-equipped to render and, indeed, have been rendering for many years in this country?

What are the reasons for this surprising and disturbing lack of public knowledge of the range and scope of our professional services, as exemplified by these two recent events? One reason may lie in the fact that we have done perhaps too good a job over the years in becoming known as professional auditors and not nearly as good a job in making our clients and the public aware of the equally important work we do every year as skilled accountants and advisors to management. Part of the cause also lies in the fact that the stresses and strains of the buoyant Canadian post-war economy have created a phenomenal increase in the demand for management consulting services, and it is being met not only by chartered accountants! Areas of consulting work which we have complacently regarded as our own for many years, such as inventory control, budgeting, cost accounting, data-processing, and office methods are being aggressively entered and developed with our clients, somewhat to our astonishment and sometimes to our chagrin, by a variety of consulting firms, which are not formally bound by any professional standards or ethics.

What is to be done about this situation? Special committees of several Provincial Institutes have been actively studying this very question for the past several years and are discovering that the problem is a somewhat complex one, to which the answers do not come easily. The professional bodies, both in the United States and Great Britain, are also investigating the whole position of the profession *vis-à-vis* management consulting.

Fact and Form

Firstly, we must not confuse the fact with the form. The simple fact is that every chartered accountant practising in Canada is, *per se*, a management consultant. It is the very essence of our professional relationships that from time to time every client will seek and obtain advice from us on matters and problems which are not directly related to the statutory audit of the financial accounts. Admittedly, in many, many cases, this professional advice is given incidentally and no special charge is made to the client for it. Perhaps a separate billing, following the lead of our legal friends, identifying item by item those specific occasions upon which matters have been discussed with the client and advice given not directly related to the audit of the accounts, is one simple, and perhaps desirable, way of calling the attention of our clients to the true nature of our professional services.

However, when we come to the form it is a different story. Here there is a fairly wide range of opinion among practising chartered accountants in Canada on the organizational form under which management advisory services should be rendered to clients. Members of our profession are currently providing management consulting services to clients under three basic organizational forms. These are: (1) as an integral part of their ordinary practices on the same basis as the other professional services of auditing, accounting, and tax advice; or (2) in association with non-C.A.'s, offering usually a broad range of consulting services, including engineering and accounting but excluding auditing and tax services; or (3) a combination of both, usually as a limited company, in which one or more partners of a practising firm of chartered accountants are directors and officers, as well as shareholders.

Within the first group, that is members who consider management advisory services to be an integral part of their professional practice, there is a wide range of development. At one end of the range are the individual practitioners and the smaller firms, many of whom devote a large proportion of their total professional time each year to work which can very definitely be classed as management consulting, much of it in the financial field. At the other end of the range are some of the national firms of chartered accountants, which maintain well-established and sizeable management advisory service departments, headed by one or more partners who devote full-time attention to this side of their professional practices and staffed by consulting specialists with heavy experience in a variety of fields.

The second group of members, namely those who do not combine in any way the practice of auditing or tax work with the rendering of management consulting services, are sometimes thought of, incorrectly, as non-practising members. In fact, they are practising members, in every sense of the word, but they have chosen to specialize in one of the forms of service which our profession is in a position to and does render to its clients. However, such members may often be practising in technical violation of the rules of professional conduct and the by-laws and charters of their Institutes. The by-laws and regulations of most of the Provincial Institutes prohibit members from associating with non-members in rendering any professional services which are deemed to be common to all members. Also, chartered accountants in most provinces are either prohibited by regulation, or dissuaded by Councils, from establishing limited companies to carry on their practices. Members, therefore, who practise as management consultants under this second category generally do not identify themselves as chartered accountants in the promotional literature or professional cards of the organizations with which they are associated. Often their participation in Institute affairs is limited to the payment of annual dues. For many reasons this is unfortunate, since such members, although they may presently be in technical violation of Institute rules, are making an important contribution to the development of professional practice and in many instances they may be endeavouring to conform substantially to the rules of professional conduct of their Institute.

The third group comprises chart-

ered accountants who are partners or principals in accounting firms that offer the normal range of auditing, tax and other professional services to clients, and who at the same time occupy positions as directors or officers of affiliated but separately constituted organizations operating either as limited companies or partnerships and who describe themselves publicly as management consultants.

At first glance, this third basis would appear to offer perhaps the ideal solution to the problem. These chartered accountants, on the one hand, pursue the usual professional occupations of auditing, accounting and taxation in the way which, by tradition, has become the accepted practice. On the other hand, they engage, in association with others who are not members of our profession, in rendering a broad range of consulting services, many of which might perhaps be considered to be somewhat beyond the professional competence of most chartered accountants. The chartered accountants rendering professional management consulting services under this form of organization endeavour to comply with the rules of professional conduct of the Institute to which they belong, but are always liable to encounter practical difficulties in enforcing the application of such rules on their associates who are not members of our Institutes.

Many practising chartered accountants feel, however, that this particular form of organization is detrimental to the best interests of the profession as a whole. Some fear that, in the long run, the survival of the individual practitioner or the smaller firms of practitioners will be jeopardized through the solicitation of work from their clients by the management consulting firms with whom their professional colleagues are associated; or, at the least, that it may lead to illwill and unethical practices among members. Others feel that the designation "chartered accountant" is an honourable one and that the respect and prestige which it now enjoys in the public mind will be diluted and seriously diminished by permitting the association of members, whether in limited company form or otherwise, with non-members, to offer services which are clearly within the professional scope of, and are in fact being rendered by, many chartered accountants in regular practice. They point to the legal profession, which has been able to achieve and maintain a very high standing and standards and has not seen fit either to adopt the limited liability form of organization or to permit association with non-members in the practice of any form of law. In fact, the legal profession has demonstrated over a great many years how specialization can be achieved and maintained fully within professional standards and ethics.

Most important of all, however, is not the form of organization under which we, as chartered accountants, choose to practise professionally as management advisors, but rather in the development and maintenance of the highest possible standards for the application of our skills in this art.

Let us now review some of the problems associated with the development of a specialized management consulting practice in a professional accounting firm. These problems are common to all management consulting regardless of organizational form.

Organizing for Management Advisory Services

We are concerned here with the professional accounting firm, which has decided to engage in management advisory service work as an integral but identifiable part of its professional practice. The first step, and in many ways the most important, is the selection of the man to head up this part of the practice. Most of the necessary qualifications for this type of professional activity will suggest themselves but some may bear special mention. Over and above usual leadership qualities, the candidate selected for this responsibility in a professional firm must have a well-developed interest in and liking for the work, must be a man who can earn and retain the respect of clients and associates, and must, above all, possess plenty of commonsense, good judgment and enthusiasm. If his professional training has been supplemented by a few years of sound experience in industry, this is decidedly helpful. The nature of the work is such that the candidate selected must have the qualities to become a partner of the firm sooner rather than later. Some firms have seen fit, in launching such a specialized department, to place it immediately under the jurisdiction on a full-time basis of one of the present partners, whose first task is to develop a capable second-in-command, who will be qualified for admission to partnership in the not-too-distant future.

The range of services offered will generally be prescribed, and properly so, by the collective qualifications and abilities of the director and members of the staff of the management advisory services department. This range may, of course, be extended, but at the judgment level, by the experiences and abilities of the partners of the firm itself. Since the firm's professional reputation is at stake in every assignment accepted from a client, it will be apparent that the acceptance of work for which the firm is not appropriately qualified is unwise if not unprofessional. The minimum size of a management advisory services staff unit that can encompass a reasonable range of services is considered to be four. This includes the director who must be a chartered accountant and who should usually be a partner or principal of the firm, and the other three members, respectively specialists in (a) administrative practices, (b) costs and (c) mechanized accounting.

The exceptionally high standards which must be applied to management advisory work, if a successful practice is to be developed with the firm's existing clientele, demands great care in the selection of personnel. The average client is averse to permitting his business to be a workshop for training would-be management consultants, and this poses one of the more difficult problems in developing a sound consulting practice. There is no such thing as an amateur consultant, but it must be and is recognized by clients that there can be trainees in a management consulting practice. In such cases, when trainees are placed on assignments, it is vital to identify them as such with the client, and to have them under the close direction of a supervising specialist at all times. Perforce, therefore, in starting a management advisory practice as a specialized department of a firm of chartered accountants, some attention may have to be given to assigning to such a unit either one or more of the most able and experienced men in the firm, or

to recruiting from outside the firm qualified candidates who possess the requisite experience to form the nucleus of the unit and to provide necessary on-the-job training facilities for the growth of the department.

Qualities of a Consulting Specialist

It is difficult to lay down any hard or fast rule about the qualities that should be sought in the members of a consulting group. After more than a dozen years of practice in this field in Canada, I am inclining more and more to the view that the characteristics of top-flight consulting specialists do not fall into any set pattern. Academic qualifications, including post-graduate university study, are usually of proven worth, but some excellent consultants are practical men, largely self-educated. In many ways personal qualities are possibly the most important factors. In any list of such qualifications, enthusiasm, sincerity of purpose, and a good level of "grey-matter" rank high. Facility of expression, both verbal and written, is important in this form of endeavour, as it is in any type of professional work. Interestingly enough, meticulous attention to every detail is not as vital as might be expected. The ability to distinguish when meticulous detail is required, and when an intuitive analysis reinforced by appropriate evidence is what is needed, is a far more important asset. In other words to be able to see the forest, as well as the trees, is vital.

There is an old and somewhat ill-considered adage in consulting work to the effect that "if you do a good job you lose a good man and if you do a bad job you lose a good client". By implication, any man who has been in consulting work past a first or second engagement might be considered below par, wherein lies the fallacy in this saying. There is, however, a grain of truth in it, in that there is an extreme dearth of capable and well-qualified men in Canada competent to serve as management consultants. It follows, therefore, that the services of men with proven reputations in this field command a premium. There is a continuous pull on such men to assume responsible industrial positions, usually with clients to whose work they have been assigned. Sometimes such positions are to direct internal methods units, but more often they are of a managerial nature. These factors tend to make the organization of a management advisory services department a step not to be entered upon lightly by any firm, since continuity is an important consideration in client relations and in carrying out engagements successfully.

Fortunately, however, there are men who enjoy the peculiar satisfactions to be derived from this rather demanding type of professional work, and to whom the difficulties and problems associated with it present a stimulating challenge which they cannot find elsewhere. It is these men who form the backbone of any consulting practice.

Classes of Service

What types of service should a management advisory services group be in a position to render? An answer worth considering is "any work on which a principal of the firm is competent to pass judgment". Departures from this rather simple but basic principle can lead to difficulties. The significant word is "judgment". All consulting work involves

judgment of a high order. The first and sometimes the most important instance in which judgment must be exercised is the acceptance or the refusal of an engagement.

Possibly because of the respect which members of the engineering profession are generally accorded by Canadian businessmen, there is an impression that the majority of management consulting engagements must involve a knowledge of engineering principles, and should be carried out by a man who is either a professional engineer or who calls himself an "industrial engineer" or, even more euphemistically, a "management engineer". This is not so. Without in any way detracting from the varied and valuable consulting services rendered by members of the engineering profession, the fact still remains that the successful execution of a very large proportion of management consulting engagements requires no specialized engineering knowledge. Often, in fact, the training possessed by a chartered accountant, and his familiarity with the administrative and financial operations of many types of businesses, is peculiarly appropriate to the solution of a variety of business problems, especially those involving organizational planning or administrative procedures.

The services which a management advisory services group in a professional accounting firm may render are naturally determined by the qualifications and experience of its consulting personnel. Some of the activities forming a basis for the operation of such a group may include services in the following fields:

1. Management organization, including the delineation of managerial and supervisory duties and responsibilities and the development of organization charts and manuals.
2. Management controls, including budgetary control systems, management reports, capital appropriation and expenditure systems, internal operating and financial statements.
3. Financial analysis, including analyses of proposed mergers and acquisitions, sick businesses, selling-price structures and many other types of situations.
4. Cost systems, including the analysis of manufacturing and distribution costs, and the development and installation of standard and other types of cost systems.
5. Materials control, including design and installation of records and procedures, inventory planning, and procurement procedures.
6. Production planning and scheduling, including the development of quality control and inspection procedures.
7. Data-processing, including the application of methods ranging from manual and simple "one-write" systems to the most advanced form of integrated system utilizing a variety of mechanized equipment.
8. Office administration, including the development and installation of all types of office routines; the establishment of clerical standards; and office layout.
9. Electronic computer studies, including feasibility analyses; the planning of installations, design of internal checks and controls in computer systems.
10. Personnel administration, including position classification; evalu-

ation of salary structures; introduction of merit-rating plans; executive compensation and wage incentive plans.

11. Executive placement, including placing advertisements, screening applicants, and other assistance to company executives in the selection of required personnel.
12. Operations research — one of the newer fields related to the evaluation of alternative courses of executive action.

The foregoing are representative rather than all-inclusive. Common to all these various classes of service are two basic concepts: better management control and information, and maximum administrative effectiveness at minimum cost. The consultant is ever conscious of the fact that a reduction of $10,000 in expense may mean more to his client than $100,000 in additional sales. The significant feature is that not one of these particular classes of service is beyond the competence of a well-organized management advisory services group in a professional accounting firm to render to its clients with expert skill.

Reference to the studies being carried out by the American Institute of Certified Public Accountants will prove interesting in this connection and special reference is made to the article appearing in the June 1957 issue of *The Journal of Accountancy* which sets forth the results of a recent survey of management services by C.P.A.'s.

Types of Engagements

The time is long past when the retention of management consulting advice is regarded as a sign of weakness on the part of management. Quite the reverse is true. Some of the strongest and best managed companies in this country and in the United States are regular and extensive users of professional management advisory services. There are a number of reasons for this. One is that an outside, detached and objective viewpoint cannot be obtained internally. Another is that administrative changes can be accomplished with less internal disruption, and usually less expensively, by bringing the resources of an outside task force to bear on the problem, rather than by detaching administrative personnel from their regular duties to undertake the assignment. Finally, it is rare to find in any company the combination of skills and the experience in many types of business that is found in a well-balanced consulting group.

All these factors make for a very wide variety in the types of engagements for which the services of a consultant may be retained. Possibly the simplest and most common form is straight consulting advice. In such cases no detailed survey is required, but rather the advice of an experienced consultant is needed on a particular problem, to act as a cross-check and aid to the judgment of a company executive.

The next most common form of engagement is a survey, which might be either limited or general in scope. The terms of reference for a survey should always be carefully set out and agreed to by the client and the consultant before any work is undertaken. The general approach to the work should be outlined, and an understanding reached as to the time that will be required to complete it, and the probable amount of the fee. Failure to observe this essential first

step can lead to results unsatisfactory both to the client and to the consultant. It is generally a mistake to become involved in more detailed fact-finding during the survey than is necessary to support the principle of a recommendation. There is always the possibility that, for good and sufficient policy reasons, a recommendation may be rejected or shelved by a client and that the hours which have been spent in developing a great deal of detailed factual data may well prove unproductive. On the other hand, a consultant who fails to gather adequate facts to support the principal features of his recommendations may find himself in difficulties with his client.

The end result of a survey is the presentation to a client, usually in the form of a written report, of a series of proposals, stating in clear, concise terms: the feature of the existing organization or system which is deficient; the nature of the deficiency; an outline of the proposed improvement; the reasons for it; the benefits that are expected to result from its adoption, including, when applicable, an estimate of the reductions in administrative costs that are expected to be achieved; and finally the action required to implement it. Depending on the scope of the work and the nature of the engagement, a survey may require only a few days for one specialist, or may well engage the time of several men for a number of months. If an engagement is likely to extend beyond a reasonable period, such as two or three weeks, it is of great importance to arrange for regular meetings with the client to discuss the results of the work to date and to submit regular written progress reports. Wherever the work lends itself to such treatment, it is advisable to submit interim proposals on which action can be taken by the client before the completion of the main survey.

Another phase of work in which a consultant frequently finds himself engaged is the detailed design and the installation of approved changes in organization or system, arising out of a survey. It is important to lay out a clear and detailed program of work and to reach an understanding with the client as to the manner in which it is to be proceeded with. Where it can be arranged, most consultants prefer to have as much as possible of the detailed work undertaken by members of the client's organization, reserving to themselves the general responsibility for directing the work to a satisfactory conclusion. In some instances, however, it will be necessary to assign a member of the consultant's own staff, to ensure that the work is carried out properly and with dispatch, and it is in these circumstances that opportunities are presented for training less-experienced members of the consulting group, under qualified direction. The identification of each project, and the accumulation of time against it, is usually appreciated by the client and is a workmanlike method of executing a program and identifying the cost of each section of it.

Still another class of engagement, for which there is a growing demand by clients, is what might be termed "preventive maintenance" in the form of a planned rotating review of a company's administrative organization and practices. In some ways this type of review bears a resemblance to the annual audit of the financial accounts. The difference is that specialists are employed to carry out the

work and the full review may be spread over a period of several years so that possibly one-third or a quarter of a company's administrative organization and procedures is reviewed annually. On this basis the annual cost to the client of such a systems review is small, and a regular reappraisal of the administrative efficiency is provided which is valuable to management at all levels, including the board of directors. Arising out of such regular appraisals may be opportunities to initiate corrective action when procedures have departed from laid-down practice or when revised operating conditions require a change. Also, a negative report, expressing an independent and expert opinion that the client's administrative practices and procedures are in good order, is frequently just as valuable as a list of many proposed changes.

An important part of an engagement, frequently overlooked or under-emphasized, is the follow-up, after a suitable interval, to ensure that the work for which the consultant was originally engaged has proven satisfactory in practice. It is through failure to follow-up that client relationships are most often impaired. Some simple matter, which was imperfectly understood at the time of installation, may cause the entire job to be thought of unfavourably. A brief letter to the management noting that an inspection has been made and listing any points on which further action by management is required provides a businesslike conclusion to any consulting engagement where installation was a feature.

Quo Vadis?

It is interesting to speculate as to what the next decade will mean to our profession in identifying itself more firmly in the public mind as management consultants. The form in which such services should be rendered to the public will be resolved, either as a part of our regular existing practices, or in some other form, possibly in limited association with others. If the rate of growth of management advisory services as an organized part of professional practice during the past decade is a reasonable indication of future growth, another ten years should see this type of work accounting for a much greater proportion of the profession's total effort.

One feature of the growth of management advisory service as an organized division of professional practice is that it creates new opportunities for service. It enlarges both the scope of our work and our professional responsibilities. But, perhaps most important of all, it serves to attract and retain in the profession men whose particular interests, aptitudes, and skills lie in this field rather than in auditing and taxation. There seems no reason to doubt that management advisory services will be, and are being, regarded by clients as impressive evidence of our interest and efforts to provide a constructive approach to aid them in the solution of their problems. By lending to the development of the practice of management consulting in Canada the prestige and the integrity which our profession has built up by hard, arduous work over many years, we may be in a position to make an even greater contribution to the development of the country's business economy than we presently realize.

In the long run, in the evolution of our profession in Canada, it is not im-

probable that we shall emulate the legal profession and that there will come into being firms of chartered accountants specializing exclusively in management advisory services, in taxation work, and possibly in still other fields of professional endeavour. To such firms, general practitioners will refer work in these particular fields, in much the same manner as in the medical profession at present.

The growing pains currently being experienced by our profession in studying the implications of rendering professional advice to our clients in the management consulting field, as evidenced by the establishment of various Provincial Institute committees, might well lead to a broader consideration of the problem at the national level. There may be merit in considering the formation of some organization which would, in the field of management consulting in Canada, perform some of the same functions, in a sense, as those undertaken by the Canadian Tax Foundation, and by the Association of Consulting Management Engineers in the United States. There does not today exist in Canada any form of recognized professional association to which management consultants as a group may belong and which would form the medium for establishing professional standards of competence and ethics. Our profession, in collaboration with the engineering profession, might well set up a joint committee to study the entire problem, with a view eventually to forming an association in which we as chartered accountants can play our rightful part, without prejudice to our own professional interests and responsibilities or to those of others.

SMALL BUSINESS AND MANAGEMENT SERVICES

There is hardly a business client, large or small, that cannot benefit in some way by competent professional assistance and advice, but the greatest need for management services exists in small businesses. Analysis by Dun & Bradstreet of the reasons for failures of small businesses points clearly to inadequate management as being the principal cause of failure. Small businesses usually do not have well-rounded managements and cannot afford specialized staff services that larger companies have. There is every evidence that the potential market for competent and ethical management consultant services to small business is tremendous.

— From "Management Services — A Challenge to the Profession", by Roger Wellington in *The Journal of Accountancy*, October 1957.

Canadian Higher Education Under Strain

GEORGE L. COURT

VERY SERIOUS financial problems will face Canadian universities and colleges as a result of the unparalleled increase in enrolment expected within the next two decades. It has been estimated that enrolment in these institutions will be doubled within the next ten years and by 1976 will be four times its present level. This growth will result from the combined effects of increases in the number of persons of university age in the population and the gradually increasing proportion of this age group seeking to obtain a university education. The financing of the education of this greatly expanded student body will require far greater resources than have been available to Canadian universities and colleges in the past.

Organization for Higher Learning

Higher education in Canada presents a rather involved organizational picture. The institutions vary in size from small theological and "arts" colleges to large complex universities offering courses in many fields of learning. Some of the smaller colleges are completely independent academically, while others are affiliated or federated with universities for academic purposes, but are financially autonomous. Many of the institutions have some endowment funds, the income from which is used for general or specific operating purposes. However, the amount derived from these sources is comparatively small and its ratio to total institutional income varies considerably among institutions. The proportion is gradually decreasing because additions to endowment funds have not kept pace with the inflationary rise in institutional costs. Some institutions receive large grants from their provincial governments, while others receive little or nothing. While most of the larger institutions are non-sectarian, many of the smaller ones are connected with or controlled by religious denominations. Some are residential, while others draw a large enrolment of students from their own urban areas.

In the larger institutions the academic and business functions are usually separate. In most cases, under the governing charter or statute, the financial and administrative control of a college or university is vested in a Board of Governors or Trustees. Academic matters, such as requirements for degrees and the prescription of courses, are left in the control of a Senate composed of senior members of the academic staff and

representatives of alumni and professional groups. In certain instances, Senate statutes may require ratification by the Board of Governors. The chief executive officer of a college or university, who may be designated president, principal, rector, or some similar title, is responsible for the overall administration of the institution, but is particularly concerned with academic matters. There is usually also a chief business officer who has been assigned the responsibility for the business and financial administration, and its integration with the administrative requirements of the chief executive officer. The business officer is responsible to the Board of Governors, either directly or through the chief executive officer.

Canadian universities and colleges have formed two national organizations to assist them in solving their academic and administrative problems. The National Conference of Canadian Universities, which meets annually, deals principally with academic matters and the general problems of higher learning in Canada. The Canadian Association of University Business Officers (C.A.U.B.O.) also holds an annual conference to study problems of financial, business or administrative nature. Both organizations have standing committees to carry on their work between the annual conferences.

About five years ago the C.A.U.B.O. formed the Committee on Standardized Accounting for the purpose of drafting standard forms of operating statements and balance sheets for reporting purposes. These would permit member institutions to make valid comparisons of their financial positions. The committee hoped that gradually the institutions would come to use the standard forms as the basis of their own official statements, although it was appreciated that some might have to conform their statements to provincial government or other regulatory requirements.

Fund Accounting

A college or university may be the recipient of a variety of funds for a multitude of purposes. These funds fall into two main categories; expendable funds, which may be entirely spent for the specified purposes, and endowment funds, which are required by the donor to be held intact with only the income therefrom to be disbursed for the purposes for which the funds were established. All funds received are carefully segregated, and control mechanisms are established to ensure that they are managed in a manner consistent with the conditions attached to them.

At any time the unexpended portion of a fund will consist of a cash balance and/or investments. To facilitate the management and reporting of these funds they are usually classified under three balance sheet sections:

1. Current or general funds for operating purposes including operating grants, fees and other current income.
2. Capital or building funds including gifts, grants and reserves held for deferred maintenance and rehabilitation, as well as for construction of buildings and for equipment.
3. Trust and endowment funds, including endowments for general and specific operating purposes, payment of student awards and for non-operating purposes, as well as expendable funds for the same purposes.

Each of the three sections of the balance sheet will include the investments and other assets and liabilities related to the funds involved. In some institutions investments relating to trust and endowment funds have been pooled in order to facilitate the handling of the portfolio and provide a greater diversification of investments. Pooled funds share in pool investment income.

Operating Income and Expenditure

An analysis made by the C.A.U.-B.O. Committee on Standardized Accounting of the Income and Expenditure of 28 universities for 1955-56, including 5 with total income in excess of $4,000,000, 8 with income from $1,000,000 to $4,000,000, and 15 with income less than $1,000,000 in that year, may be summarized as follows:

Income	*Amount*	*%*
Student fees	$17,870,174	30.14%
Gifts, and grants for specific operating purposes	3,551,868	5.99
Receipts for services	1,401,971	2.36
Endowment income for general purposes	1,575,941	2.66
Endowment income for specific purposes	1,901,661	3.21
Government grants, federal, provincial and municipal	23,782,073	40.12
Funds received for assisted research	8,210,427	13.85
Miscellaneous	984,706	1.66
Net surplus or deficit on ancillary enterprises	8,825	.01
Total income for general university purposes	$59,287,646	100.00
Income of ancillary enterprises (less surplus above)	10,996,022	
	$70,283,668	
Net deficit for year	511,508	
	$70,795,176	
Expenditure		
Academic	$34,983,430	61.00
Assisted research	8,210,427	14.32
Administration	3,465,311	6.04
Plant maintenance	8,217,114	14.33
Scholarship, bursaries and prizes	452,019	.79
Miscellaneous	2,017,663	3.52
Total ordinary expenditures	$57,345,964	100.00
Extraordinary operating expenditures (Dept. service, rehabilitation, etc.)	2,453,190	
Ancillary enterprises, such as residences, food service, hospitals, book stores, etc.	10,996,022	
	$70,795,176	

The comparatively small net deficit of $511,508 shown in the above analysis illustrates a sincere effort on the part of Canadian universities and colleges to live within their income. It should not be assumed that they have almost sufficient income for their needs which, in fact, greatly exceed their resources. University academic salaries in general are lower than the salaries of many university graduates of equal ability and experience employed in industry and business. In addition, salaries of the academic staff of some institutions are low in comparison with those of others. Academic salaries must be drastically increased if sufficient staff is to be obtained to educate the greatly increased number of students who will wish to attend universities in the next two decades. Funds must be found for this purpose. More funds are also required for the modernization of facilities, library books, scientific equipment, adequate salaries for competent non-academic staff and other types of operating expenditures.

The foregoing summary also points out the comparatively small proportion of total income arising from student fees which is shown as only 30.14%. Fees which have been increased progressively since 1945 now vary from $300 to over $500 for most courses depending on the course and the institution. It seems unlikely that student fees can be increased further unless additional loans, scholarships or bursaries are made available to help students who have the required academic standards but lack the necessary financial resources.

A major source of income for Canada's institutions of higher learning is in the form of government grants. Grants received by the 28 institutions reporting for 1955-56 may be summarized as shown below.

The figures below illustrate the great dependence of universities and colleges upon government grants, particularly from the provinces which are constitutionally responsible for educational matters. The federal government's general grant to universities and colleges, recently doubled, now amounts to one dollar per capita of population in each province, divided among the institutions therein according to the number of eligible students in each institution. Although doubling of the grant has been halted by the universities as a great step forward, it provides only a portion of the funds required to overcome present difficulties and provide for necessary future expansion.

Endowment income for general and specific purposes amounts to only 5.87% of total income. Since endowments have not been expanded as rapidly as expenditures, the income therefrom represents a decreasing proportion of total income. Because of high succession duties and income taxes, as well as the present tendency

Grants for:	*Federal*	*Provincial*	*Municipal*	*Total*
General purposes	$ 4,428,007	$19,095,642	$ 258,424	$23,782,073
Specific purposes	75,411	1,200,764	35,650	1,311,825
Research	5,115,096	612,824	2,139	5,730,059
	$ 9,618,514	$20,909,230	$ 296,213	$30,823,957
% of total income	16.22	35.27	.50	51.99

of wealthy men to establish foundations to distribute the income from their estates, endowments have not increased as rapidly as in the past when so-called privately endowed institutions built up their endowments. For the same reason, it is unlikely that the proportion of institutional income from endowments will increase in the future, but rather will probably continue to decline.

For the future, therefore, the universities and colleges must look to governments for expanded grants and to industry, business, alumni and friends for increased annual contributions. Due to our increasingly technical civilization, business, governments and the professions including accountancy are requiring more and more university trained personnel. As the chief beneficiaries of our system of higher education, next to the students themselves, it becomes necessary for them to make certain that the future income of Canadian institutions of higher learning is adequate for the job that must be done.

Future Nceds

The modern university is a complex organization called upon to offer many services to its students, staff and the public. Its functions vary considerably according to its size and location. In addition to a regular teaching program it may provide such facilities as advanced research laboratories; student residences and dining rooms; student unions; athletic programs; hospitals and clinics; computing centres; bookstores, publishing and printing services; evening, summer and correspondence courses and even Conservatories of Music and Museums. A university's staff is also a pool of qualified personnel available to governments and business for advice on technical problems and for membership on investigating commissions.

Because of the increasingly technical aspects of our civilization and the complexity of our social organization, university research has considerably grown in amount and scope in the last 15 or 20 years. While it has been financed largely by grants from government organizations, the universities have had to provide the supervisory staff, the administrative services and the physical facilities to accommodate the staff and equipment.

The doubling and redoubling of enrolment of Canadian universities and colleges within the next 20 or 25 years presents many problems. The internal organization of the institutions will have to be reviewed continuously to assure that teaching standards are maintained and improved. Given the financial resources, organizational problems can be overcome. The most serious problem facing Canadian institutions of higher learning is concerned with the acquisition of these large and essential funds.

Vast amounts of money will also be required to provide physical facilities. The preliminary report of the "Royal Commission on Canada's Economic Prospects" states that "it is estimated that capital expenditures of about one billion dollars will be required for these purposes over the next 25 years". This is at the rate of about $40,000,000 per annum, an amount more than twice the average annual increase in the investment in the institutions' fixed assets since 1945. The pressure of the large postwar veteran enrolment and the lack of maintenance funds over the pre-

ceding 15 years means that many of the older buildings now require extensive repairs and modernization of facilities to bring them up to reasonable present-day standards of efficient operation.

The operating requirements are even more startling. In the submission of the Ontario Government to the Royal Commisison on Canada's Economic Prospects, it is estimated that, based on an average cost of $1,200 per student, the outlay of Ontario institutions would expand from $23,500,000 for 21,400 full-time students in 1954 to $54,300,000 for 45,300 students in 1965 and to $111,100,000 for 92,600 students in 1975. It should be noted that these figures are based on 1954 costs. They do not allow for general inflation and, in particular, for the higher salaries that will have to be paid to academic staff members in the future to compete with government, business and industry.

The universities and colleges of Canada are ready and willing to assume the responsibility of educating the vastly increased number of students expected in the future. They can solve their organizational problems and meet this challenge if they are given sufficient financial resources to obtain the capital and human resources to do the job.

A New Crisis

In 1945 there was a comparatively short-run problem, created by the great post-war enrolment of student veterans, which rose to a peak in about 1949 and declined soon after. That crisis was met by setting up temporary facilities and by increased teaching loads, larger classes and extended hours, with adverse effects on the teaching staff. The maturity of the student veterans made the effort possible. In the new crisis, enrolment will insidiously increase year after year in the foreseeable future and be fraught with dangers, since in some areas of instruction additional students can be absorbed, thus obscuring the fact that ultimately larger and improved facilities will be required.

Since it takes two years or more to plan, build and equip a building, and even longer to acquire, train and integrate new staff members, the universities and colleges of Canada require assurance that the necessary funds will be available when needed. Once this assurance is obtained they will be able to plan the facilities and acquire the necessary staff to increase the flow of university graduates so necessary to Canada's future technological and cultural development.

In the summary of the income and expenditure of 28 universities and colleges for 1955-56, $452,019 was shown as expenditure on scholarships, bursaries and prizes. This is only the amount of such student aid provided by institutional budgets, and does not include a much greater sum available from other sources, such as endowments and annual gifts and grants for scholarships, fellowships, bursaries and loans to assist students in financing their college education. Even now more funds are needed for student aid, but as student enrolment increases, the funds required will increase proportionately.

Opportunities to Help

A large part of the total sum required to finance the expansion of Canadian institutions during the next

20 years must come from government sources. Nevertheless, there will be many opportunities for individuals and corporations to do their share. Public appeals are now being made, and will continue to be made, for capital and operating funds and for student aid. It is hoped that the response will be generous. In addition, corporations may wish to assist the work of particular departments in which they are interested by gifts of funds or equipment to supplement the resources of the institution, or to provide scholarships and fellowships to encourage study in these departments. Private individuals can perform a great service by bequeathing a part of their estate for the construction of buildings which are not always permissible under government capital grants, such as residences, dining rooms and athletic facilities, and for research, scholarships and bursaries.

The profession of chartered accountancy obtains such a large number of its students from university graduates that the members of the profession should inform themselves on the problems of the universities and should in whatever way they see fit encourage and assist in overcoming them.

The needs are great and immediate, and they will continue. Adequate assistance, both now and in the future, is essential if Canada's demands for educated men and women are to be met in the years that lie ahead.

THE AGE OF AVOIDANCE

Speaking at a luncheon of the British Institute of Management at Birmingham, Lord Piercy said:

"We have reached a point today where, throughout society, whether rich or poor, individuals or companies, there is a great uneasiness about the rate of taxation and a great tendency to try to shift some of it off. To use one of the titles used by the historian, Arthur Bryant, you might call this the Age of Avoidance."

— *Taxes*, April 1957

The Verification of the Existence of Assets

JAMES A. de LALANNE

Mr. J. A. de Lalanne is president of the Canadian Institute of Chartered Accountants. He presented the following paper in September at the Seventh International Congress of Accountants held in Amsterdam. It is an outline of his views on the procedures which should be carried out by the auditor to satisfy himself as to whether the physical volume or quantity of assets is correctly stated in the client's accounts and of any variations in procedure as regards the audit of annual accounts and investigations.

VERIFICATION OF the existence of assets must be considered in two parts: first, that the particular asset, whatever type it may be, is either physically in existence or that the right to it does exist and, secondly, that the physical asset or the right belongs, in fact, to the individual or company whose accounts are under audit.

The first audit usually calls for certain procedures and verifications which need not be repeated to the same extent in subsequent examination; also, the same test need not all be repeated every year, but over a cycle of years all phases of the client's operations should be covered in reasonable detail, having regard to the client's own system of internal control and the extent and effectiveness of any independent internal audit.

Value of Personal Observation

Before discussing the methods and procedures which should be adopted by the auditor to satisfy himself of the existence of various types of assets, personal observation or inspection by the auditor, where feasible, should be the starting point for all verification.

For many types of assets this is only a partial verification and does not necessarily prove ownership. On the other hand, in addition to other merits, it has the advantage of giving the auditor a first-hand knowledge of the assets and the nature of the undertaking with which he is dealing, the size of the client's operations and a general knowledge of the procedures and of the division of duties as between the responsible employees.

While it is sometimes essential that a physical inspection be made of certain types of assets at or near the date of the fiscal year end, with

control being maintained as circumstances dictate or permit, it is very desirable that such a verification should be supplemented by other "surprise" counts or confirmations, especially for those assets which fall within the current or liquid class.

Without such additional safeguards and the knowledge by employees (even officers of the company) that no further inspection is likely to be made until the next year end or periodical fixed audit, there is much more opportunity for substitution and/or misappropriation of funds, securities or inventories and for systematic defalcation in customers' balances, even before the auditor has completed his current task. The frequency of such surprise tests will be dependent on many factors. To be most effective, they should be varied from time to time both as to date and procedure.

Types of Assets

A few comments may be made on the various types of assets.

Fixed assets with little or no turnover, which cannot normally be substituted (e.g. land and buildings)

The extent of the investigation to be made in connection with these assets will depend on the nature of the business, the number of properties, their size, and their location, but it is most important that, if practicable, the auditor should from time to time visit all properties, view any additions or demolitions, note the type of structure and become familiar with the uses to which they are put. This not only satisfies the auditor that the properties actually exist but it gives him information which is of assistance, for instance, in interpreting the particulars contained in the relative deeds or supporting documents and in forming an opinion as to the adequacy of accumulated depreciation and of depreciation rates in use. In most instances the time of the visit or the frequency is not a very serious matter so long as the records indicate that the properties are in reasonably full operation.

The second step is a thorough examination of the deeds and such registrations as may be required by the governing political authority. Where the properties are numerous and it is not feasible for the auditor to examine in detail all the supporting deeds and documents, he should ensure that his client maintains a proper record of all properties with particulars of all acquisitions, disposals and abandonments. Where such record exists, a comprehensive test is usually sufficient.

As part of his program, the auditor should, of course, scrutinize all minutes, agreements and contracts, examine the relative tax bills and insurance policies and adopt such other practices as might seem appropriate to ensure that there are no prior liens on any of the assets.

Fixed assets (with a lower turnover) which are difficult to substitute (e.g. machinery and equipment, furniture and fittings, vehicles, etc.)

Periodical scrutiny of machinery and equipment, and a careful check of all additions, replacements and disposals would normally suffice for fixed machines and equipment. For movable equipment such as office machines and vehicles, a physical inspection and comparison of serial numbers is the most effective verification.

In large undertakings, it is normally not practicable for the auditor to make frequent detailed verifica-

tions of the existence of all the assets falling within this class and therefore more reliance must be placed on the client's own records.

In industries such as transportation, trucking and construction where the owners generally adopt a numbering system of their own for rolling stock and other pieces of equipment, the auditor is more likely to be able to make appropriate test checks and establish controls to assist him in determining that the relative assets are satisfactorily accounted for.

Current assets (with a higher turnover) which can more easily be substituted (e.g. stocks of raw materials, work in process and finished goods)

In the matter of inventories, the situation is more complex and personal inspection by the auditor from time to time is most desirable. Three important factors are the physical existence of the product, quality, grade and condition of the merchandise in question, and ownership.

Confirmation of existence and of quantities should not normally be too difficult in the case of raw materials and finished goods, where a physical inspection can be carried out and when suitable and adequate records are maintained for receiving and shipping and of movement within the plant.

It is difficult to separate a study as between "physical existence" and "valuation" as the auditor will no doubt wish to compare the quantities and qualities with invoices for recent deliveries to the plant and to ensure that the styles and qualities listed for the stock on hand are in agreement with the relative particulars recorded by the supplier in his invoices. Special care should be taken to ensure that the materials or supplies are actually owned by the company and taken into its account and that they have not been received on consignment.

As regards *finished goods*, the procedure is somewhat the reverse of that for raw materials in that studies should be made of production and of quantities represented in sales, with appropriate inquiry as to whether packaged goods still remain in the ownership of the client or may have been packed and invoiced prior to the inventory date but held for later shipment.

Work in process is usually one of the most difficult for an auditor to verify and in this connection he must, to a great extent, rely on the accuracy of the client's costs or working records — supplemented by such personal observation as may be practicable.

Of course there are many types of business where it is virtually impossible for the auditor to carry out, either himself or through his associates, anything more than a cursory inspection of stocks. In these instances, it is necessary for him to pay much more attention to the company's records of purchases, production and sales, the rates of wastage learned through experience, possibility of theft and pilfering, obsolescence, and all the other factors which go to reduce quantity and quality.

He must also satisfy himself—

Of the sufficiency and accuracy of the client's records and his method of stocktaking.

Of the practices adopted in establishing quantities and grades of merchandise and in determining slow-moving and/or obsolete stocks.

That there was a simultaneous closing (so-called cut-off) of receiving, production and shipping records coincident with the commencement of the actual count.

That there was adequate control of the movement of stocks within the plant during the period of stocktaking in instances where production and shipping must, of necessity, continue uninterrupted.

Claims or rights incorporated in documents, which can be easily substituted (e.g. securities, bills receivable, warehouse certificates and cash)

While in many types of business it is desirable and necessary to make actual physical counts of cash securities and bills receivable at the fiscal year end, it is suggested that physical counts with an element of surprise are the most effective, especially as regards the discovery of substitution or other types of defalcation.

Maintenance of control during any physical inspection of assets of this type is extremely important with special cognizance being taken of "due dates" and "endorsements", where applicable.

Where it is necessary to prove existence and/or title by means of written confirmation, the form of the request or of the confirmation to be returned should be carefully designed so as to include all relevant facts and disclosure of any accounts which might be temporarily dormant.

Where more than one party has an interest or responsibility in any transaction, confirmation should be obtained from each, e.g. bills receivable under discount.

Certain organizations such as stock exchanges stipulate that the independent auditor reconcile and confirm bank balances both as of the audit date and as of a date subsequent thereto.

This practice has considerable merit in the case of other types of assets included in the group under discussion.

Long-term loans or receivables

These are normally covered by some type of document such as a notarial deed or formal contract. The auditor should ascertain whether all legal requirements of these documents have been met by the borrower and appropriate steps should be taken to ensure the existence of any security which may have been pledged against the respective asset. For example, in the case of negotiable securities, confirmation or inspection should be made. Where the security is in the nature of a fixed asset, other documents as well as tax bills and insurance policies should always be inspected, confirmed and, where observation by the auditor is not feasible, other inquiries made as to the existence of the security and that there are no prior liens or rights against the security pledged.

Short-term receivables

The nature and size of the business and other relevant factors will usually dictate the procedure to be followed in verifying receivables, e.g. the extent of the coverage, the frequency of inspection and of direct communication with debtors, either in positive or negative form of confirmation.

In addition, extensive tests should be made of the source of the charges, terms of credit, experience of collection, method by which the debtor pays, whether for the exact charges

or by lump sum payments, and whether any items appear to be in dispute.

Credit notes issued subsequent to closing date should also be scrutinized to ascertain whether any applied to the period under audit and the reasons for and effect of the issue of same.

This is another instance where it is difficult to separate verification of "existence" and of "valuation".

Investigations

In the case of investigations where the auditor is in a less favourable position to form an opinion on the adequacy of the system of internal control and where time dictates a more restricted examination of the accounts than in the case of a general audit, the auditor must consider the nature of the business concerned, the volume of its operations, the comparison of both its balance sheets and operating accounts over a period of years with a thorough inquiry into any assets or liabilities, income or expenditures which would appear out of line in the final period as compared with the experience in prior years.

Where feasible, observation of the physical stock on hand is most important and in many instances the engagement of independent specialists may be desirable except in cases where, for instance, the purchaser of a business can send in his own experts to appraise the quality and quantity and value of stock. In the case of an appraisal for purchase or sale of a business, for example, the auditor is seldom capable of expressing an opinion on the realizable value of properties such as land, buildings and machinery, and it may not be practicable for him to make a physical inspection of all properties. The report of any recognized independent appraisers specially engaged for the purpose or who may have carried out a recent inspection of the properties would be most helpful in such a case.

One of the problems which often confronts the auditor in the case of an investigation is the secrecy which must be maintained, sometimes coupled with urgency. This occurs in various ways and for many reasons but limits considerably the extent to which the auditor may have access to certain of the basic records and often precludes his discussing underlying principles with the persons who actually must carry them into effect. Consequently, investigations impose on the auditor greater need for sound judgment, tact and capacity to work under pressure and he must give due consideration to trends in the particular business and in the industry in so far as statistics may be available, bearing in mind the dangers of placing too much reliance on comparisons even of companies in the same type of business.

General Views

As regards certain of the points specifically referred to in the "terms of reference", my views are as follows:

The auditor is justified in examining certain assets less frequently than once a year, e.g. distant properties where it can be seen that buildings and equipment and other facilities are being used to reasonable capacity for the company's operations and where he has no reason to believe that they have been sold, destroyed or abandoned.

In determining the frequency of stocktaking and the examination of

assets and in fixing the time and scope of such inspection, consideration should be given to the possibility of substitution and the frequency of movement.

Stocktaking at the close of the fiscal year does prove the existence of the particular materials or other assets as at that date and, if a complete coverage can be made simultaneously, minimizes the possibility of substitution or transfer between departments or warehouses. This method is necessary and desirable for many industries and particularly where it is impractical to maintain perpetual inventory records, or where a gross profit method of computation is not feasible.

On the other hand, the speed with which an overall count must be made for some types of operation sometimes offsets the advantages which accrue and more satisfactory results are obtainable through periodical checks of stocks throughout the year, and a normal experience determined as regards wastage, shrinkage, pilferage and the like. Surprise test counts at times other than the closing date are normally found most advantageous in detecting frauds, thefts and other forms of misappropriation. It is not suggested, however, that this should eliminate entirely physical checks of stocks at the year end.

Where practical limitations reduce the opportunity for the auditor to make personal inspections, he will be more dependent on perpetual or other inventory records maintained by the client and must pay particular attention to the client's method of control, internal checks or audits carried out by his own staff or by independent persons, and must apply such other yardsticks as may be available to him in determining quantities and qualities.

Attendance at physical stocktaking and the inspection of cash and securities are most important in verifying the accuracy of balance sheet items. As regards cash and securities, the auditor will normally assume full responsibility for a personal or independent verification. Unless he is so required by his terms of engagement, he should not assume the responsibility for the actual stocktaking of merchandise but should cooperate and assist in such stocktaking to whatever extent he feels desirable or as requested and should observe the methods and procedures to satisfy himself that quantities are being properly recorded and that the descriptions of the various types of goods are such that will permit the client's staff to place proper valuations on the inventories.

Wherever possible, a study should be made of the accounts for the period subsequent to the date of the balance sheet with particular reference to cash received, deposited, collection of accounts receivable, discounts allowed and sales of merchandise in relation to the inventories listed as on hand at the year end. For example, an abnormal falling off in sales following the close of the year might indicate insufficient stock on hand to make the required deliveries and suggest further tests.

The obtaining of written confirmation directly from depositories such as bankers, consignees and warehousing companies and from third parties in the case of advances, loans and receivables is, in my opinion, a key part of every audit or investigation. The frequency and manner in which these may be requested is a

matter for each individual assignment but should not preclude occasional inspection by the auditor.

Where assets are held in custody for others, verification should be carried out in a similar manner.

In regard to the extent that an auditor requires expert knowledge as to the nature of the assets of the company, this is certainly always an advantage, and in some instances may be essential, possibly more often for valuation rather than for verification of existence. However, in both instances the usual general rules would apply and if the auditor has made a comprehensive study of the client's products, methods of operation and control of stocks, he should normally not need specific technical knowledge for adequate stocktaking.

In assignments where the auditor does not have sufficient technical knowledge to carry out an adequate stocktaking by himself, he would be well advised to engage independent experts to assist him if his terms of engagement or the local law under which he practises requires him to personally make a physical count, independent of the client's staff.

If, on the other hand, the responsibility for compiling the inventory rests with the client, the auditor would not normally engage independent experts, unless he had reason to believe that styles and/or quantities were not being correctly stated or in cases where sufficient data was not available to him to form an opinion as to the thoroughness of the procedures adopted by the client.

As to the question of technical suitability, the auditor could not reasonably be expected to pass on the suitability of each and every item appearing in the inventory. He would, of course, take the precaution to inquire as to orders in hand and the client's ability to fill such orders, to ascertain that the stocks are not excessive in relation to current sales or shipments, and in comparison with inventories required in the past and that there have not been an unduly large number of returns by customers.

Provided quantities and qualities were correctly stated, the question of possible obsolescence due to pending inventions or a tapering off in demand due to general business conditions would be a matter of concern for those placing the appropriate value on the stocks in question.

The auditor's responsibility is governed either by the statute under which he practises, or by his terms of reference.

Except for such matters as may be specifically excluded in the terms of engagement, the client may reasonably expect that the auditor has satisfied himself on all material facts not subject to a qualification in his report. The auditor's responsibility would not, however, in any way be reduced by his lack of technical knowledge, in so far as third parties are concerned, even if he has been relieved by the client of certain responsibilities.

Conclusion

In the foregoing, the comments have been restricted to the classification of assets and types of business which are most common and have not attempted to discuss other types which appear less frequently in financial accounts.

However, in all instances, existence, ownership or title can best be proven by the application of the

same general principles which may be summed up as follows:

Actual count or personal observation.

Written confirmation or other documentary evidence where physical inspection is not feasible or appropriate.

Comprehensive examination of the client's records.

Intelligent study of the client's practices and procedures.

Exercise of sound judgment and meticulous care on the part of the auditor in the planning of this program, having in mind the importance of variation in coverage, methods and timing.

WHEN IS JANUARY 1?

There is more than a hint of the ingenuity of the barrack-room lawyer in the argument addressed to the Court-Martials Appeal Court in the case of *R.* v. *Logan and Others,* [1957] 2 All E.R. 688, 3 W.L.R. 335. A corporal and three sappers of the 24th Field Engineer Regiment were convicted by a court-martial in Hong-Kong of committing a civil offence (not specified in the report) at 2.30 A.M. on January 1, 1957, contrary to the Army Act, 1955. The latter Act came into force on January 1, 1957. It was argued that the Act came into force on the first moment of January 1, Greenwich Mean Time; that Hong-Kong was about eight hours in front of Greenwich Mean Time; and, accordingly, that at 2.30 A.M. on January 1, 1957 in Hong Kong the Act was not in force there. Despite this splendid and courageous argument, the Court dismissed the appeal, holding that the Act came into operation in relation to British troops on the day which was January 1 in the place where the troops were.

— from *The Accountants' Magazine,* September, 1957.

Organization of a Credit Department in a Company

M. C. LUKE

"EVERYONE knows what a credit man does" is a saying which denotes a typical attitude, but regrettably his real function in an industrial or commercial enterprise is not widely known and is often imperfectly understood. To many people, credit is largely a matter of securing a Dun & Bradstreet report on a customer and collecting accounts. To be sure, a credit man does this but it is an extraordinarily narrow conception of his function, as narrow as if one was to say that an accountant's job was merely to record figures properly under account headings. Yet a surprisingly large number of companies have so-called credit departments which do little more. Particularly in small and medium size companies, but also in some larger ones, there has been a strange reluctance to determine the real responsibilities of credit management and to delegate appropriate authority.

What is Credit?

Credit has been defined as a power or ability to secure goods or services in exchange for a promise to pay later. Looking at it another way, John Stuart Mill called it "the permission to use another's capital". It is possible to read into these two definitions that credit is merely passive, but it takes little imagination to recognize that they imply something much wider and more dynamic. In the abstract sense, the purpose of credit is to facilitate the distribution of goods and promote production and and consumption. The reason an individual company sells on credit is to achieve maximum profit, on the basis that normally an increased volume of sales has this result. There is a calculated credit risk involved in this approach. Bad debt losses are to be avoided as are overdue accounts, and yet both may be fully justified when related to the profit realized through increased volume.

Credit management is not merely complex, detailed and technical, but is an active phase of marketing or distributing goods and is directly responsible for the management of the assets involved in the translation from inventory to accounts receivable and cash.

Location of Credit

The location of the credit function in an organization has been receiving increased attention. In most companies today, credit managers re-

spond to a treasurer. The credit function may, however, be found in the distribution organization, particularly if the company has a well developed sales-oriented philosophy or the industry is highly competitive and emphasizes customer service and relationships.

The "best" place for the credit unit in a particular company may be difficult to decide. It can and does operate reasonably successfully within both sales and financial organizations. The writer feels that, having regard to all the considerations involved, logic will eventually establish credit management on a completely autonomous basis reporting to top general management, as has evolved in other specialized or technical functions such as purchasing, traffic and employee relations.

Bias in credit management is anathema, and, although there are other objections, bias lies at the root of most challenges to placing credit under either the treasury or the distribution units. In all line relationships downward, there are pressures, witting or unwitting, which colour attitudes and determine courses of action, and it is, on the whole, good that this should be so. However, the drive for sales volume and the conservation urge in finance are ultra strong motivating forces, so strong that credit should not be directly exposed to their control. Competent credit men should be in the best position to estimate and calculate the probabilities in a given credit situation. The more direct their relationship to general management's thinking and policy, and the more independent their status opposite sales and financial management, the more likely will their decisions inure to the benefit of the company concerned.

Structure of Credit Unit

Considerable thought has also been given recently to the type of structure required to give effect to sound credit objectives. Credit units have many forms, although the greater number of companies are not of a size or so diversified that they require a complex credit organization. Their structure becomes significant when the companies involved are larger, both in respect of geographical area and multiplicity of product.

The problem of structure concerns the relative merits of "line" versus "staff" organizations and of centralization versus decentralization. By "line" is meant the administering or decision-making type of action; "staff" emphasizes advising or recommending. Centralization and decentralization refer to management authority, *not* geography, which refers to physical dispersion only. Much could be written about these four types, and examples of every gradation involving the four can be found in credit.

The principal factors in determining the credit structure are:

1. Control over assets and adherence to policy on credit.
2. Nature of the corporate organization structure.
3. Geographical aspects including sales coverage, close relations with customers, speed in decision, etc.
4. Product distribution problems, wholesaling, retail dealership, direct to consumer selling, etc.

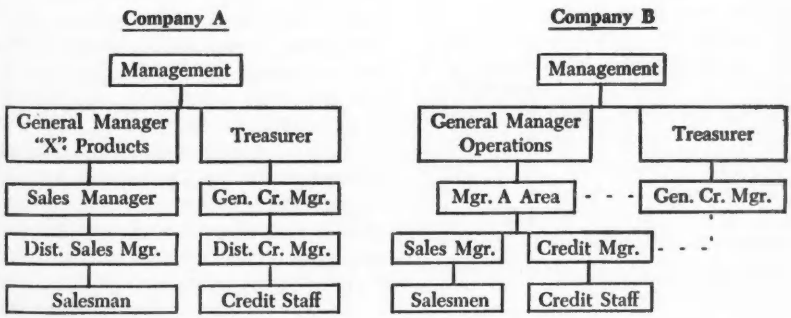
Centralized corporate structures do not present unusual credit organization problems, but when corporate policy is to decentralize, there is the question of how to obtain uniform adherence to credit policy. There is no end to the practical and theoretical points that can be raised in support

of particular approaches to the solution. Generally there is little disagreement in relation to geographic or distribution problems.

Broadly the argument for the "staff" concept is that the head of a decentralized unit, if he is to be held responsible for end results, must have authority and responsibility over all that affects his operation, e.g. terms of sale, sales, production, shipping, credit, purchasing. He should be required to adhere to general company policy, including that relating to credit, but day-by-day execution of policy would be left to him. Therefore, a general credit manager or top credit man, although responsible to the management for corporate credit policy, would have no direct responsibility for giving effect to it and would have advisory powers only — a "staff" function.

The difficulties in controlling credit under such an arrangement are obvious. Taken as a whole, therefore, credit departments tend to be "line", and there seems to be a switch to this concept even among decentralized and dispersed corporations. A recent study of the Credit Research Foundation states, "The general credit executive is responsible for the credit function within this corporation. In order to carry out that responsibility—and be held accountable for it — he must have the necessary authority. In order to achieve decisive action quickly — thereby keeping the credit function geared to both the company and the industry — and to unify the corporation's credit policy, the chief credit executive must be given direct authority over all of the company's credit departments."

To illustrate the essential difference between the two basic types of organization the chart shown below may be of interest.



TWO TYPES OF ORGANIZATION

The solid lines indicate "line" authority, the dotted lines "staff" relationship.

In the case of Company A there could be several product divisions, but opposite each the line responsibility for credit would remain as illus-

trated in the chart. Similarly, in respect of Company B, the general credit manager would have the same staff relationship opposite other area or regional managers, who would also have sole responsibility for day-by-day credit decisions in their areas.

Geographic and product distribution problems, on the other hand, affect not so much the type of organization as its size and the degree of dispersion. There are usually wide differences in policy and practice between sales on credit of consumer goods and industrial goods. For example, the hardware retailer presents his supplier with a vastly different credit problem from that of a large newsprint manufacturing company. Manufacturers of basic goods, such as tanners, textile and automobile manufacturers, differ widely from those manufacturing style goods. Another contrast lies in the difference in the conditions surrounding sales of established products and those for which the market, and in many cases the converter intermediary, must be developed. Some companies with a concentration of customers in the highly industrialized areas of Quebec and Ontario have relatively local problems. Others sell a wide variety of products, both industrial and consumer, through a nation-wide organization.

The preceding barely highlights the infinite variety of differences which have to be taken into account in determining the most effective and appropriate size and degree of dispersion for a credit organization. It is suggested, as the guiding principle, and with due regard to the economics of the operation, that the closer the credit man is in direct contact with sales personnel, customers and sources of information, the greater will be his contribution to the profits of his company. A large diversified national company could well expect a "line" credit department with district managers and staff in the Maritimes, Quebec, Ontario, Manitoba, Alberta and British Columbia.

Degrees of Authority

Where efficient credit control demands a dispersed credit organization, the question arises as to degree of delegation of authority and responsibility to permit fast decisions based on local knowledge of all influences without loss of control. Control is not necessarily lost by full delegation of authority to act. Delegation is a two way street, and implicit in it is a duty of the recipient to protect the delegator. It does not preclude consultation or recommendation, but rather encourages it. Therefore, the full authority for local decisions should be delegated to district credit managers. Delegation to the district level should be as complete within the area as it is to the general credit manager from his superior.

At the district level occurs the translation of policy into practice. There are four main areas of responsibility attached to a district credit manager's position:

1. In addition to normal supervisory duties, a particular responsibility to keep his superior informed on company and general conditions and results in his area, and on ways and means of meeting new conditions.
2. Credit work
3. Collection work.
4. Maintenance of accounts receivable records. The advent of electronics has given seeming advantages to the centralization of

these. However, in large offices particularly, detailed accounts receivable records are of major importance in credit and collection work, and any move in this direction should be made only after careful examination of its impact.

A characteristic of credit work is tremendous volume, but a substantial part, possibly as high as 75%, is of a routine nature which can be handled by relatively junior personnel. Another major factor is time, for it is essential to a progressive distribution policy that credit decisions be made quickly, as well as soundly, and that collection work be so scheduled that prompt follow up of overdue accounts is automatic. Similarly, bookkeeping must be kept up to date. Ledger records that are a week in arrears and unreconciled with customers' books are of little use to busy credit and collection men.

Another important aspect of credit work is the need for information. It is the grist that feeds the credit man's mill, and arranging a full flow of it is vital. It embraces chiefly customer information; district sales policies, practices and problems; local and specific trade economic conditions and such general influences on conditions as governmental subsidies and controls. The sources of information must be constantly stirred up and the channels by which it will arrive kept clear and workable. Senior credit personnel must spend a great deal of their time in contacts with salesmen, customers, other credit men, bankers and so forth.

Lastly a credit man must have time to reflect on and digest the information so that as each credit decision is made, due weight is given to all relevant influences.

Levels of Personnel

With these three things in mind, it seems logical that a district credit organization should have three distinct levels: management, technical assistants and stenographic-clerical workers. In a simple, uncomplicated situation, this could mean a staff of three. Normally volume affects first the worker level, then the intermediate level. Complexity of problems, arising from multiplicity of product or type of customer sold in a particular district, would determine the number of second-in-line credit personnel. A large volume, highly diversified and marginal risk type of operation could require a structure as indicated in the following chart.

District Credit Manager
- Credit and Collection Supervisors (3)
  - Credit and Collection Assistants (3)
- Accounts Receivable Supervisor
  - Invoice Clerk
  - Reconciliation Clerks (2)
  - Bookkeeping Machine Operators (2)
- Senior Stenographer
  - Stenographer-Typists (3)
- Cashier

The direct reporting of a cashier to the district manager (or preferably an assistant manager if there is one) is desirable in order to separate cash receiving and ledger posting, thus minimizing the possibility of defalcation. There appears to be merit in requiring the senior stenographer to act as a work leader in allocating the work load. The accounts receivable supervisor's duties are fairly obvious, but it should be emphasized that an efficient bookkeeping staff can be of great assistance to the credit and collection personnel in their daily work as well as in the production on

a regular basis of statistical control figures for measuring results.

In an operation of the size contemplated by the above chart ($40 million to $50 million, with 10,000 to 20,000 active accounts) more managers fail in their job for administrative reasons than for technical ones. Usually they do not force themselves to drop their familiar technical work and insist on becoming too personally involved in the daily flow of work at the expense of their other duties. The manager must be a planner and leader and it is essential that he clearly place the responsibility for day-by-day credit decisions on his next-in-line supervisors (who may be responsible for areas or groups of products, etc.), retaining only a minimum of accounts which for one reason or another he should handle himself. If this is done, he will enjoy the incentive of "being his own boss" in his area, and the credit supervisors, in their more limited area, will gain a sense of personal responsibility that cannot be obtained in any other way. It is even worthwhile carrying this concept one stage further to the credit assistants, although admittedly the nature of the work, mostly collections, would permit less scope.

Many companies need to make a complete review of their credit management: the scope of the job, its status as a quasi profession, the desirability of the "line" concept for uniform control and a full measure of decentralized authority within the line organization.

MANAGERIAL TALENT

Some years ago a university student obtained summer work on a field party of the United States Geological Survey. His party was one of two running a line in unsurveyed territory. They worked the line from both ends toward the middle. In due course the two parties were to meet and join up their lines. When the two parties did meet it was found their lines diverged, and the university student was immediately blamed for the error by *his* party chief. The other suggested that instead of firing the boy they should first go back over the separate lines and find where the error occurred. This check revealed the mistake was not the boy's but was in the other party. So he was not fired, and he went on to become a great geologist. His name is Gene Holman, and he is chairman of the Standard Oil Company of New Jersey.

— From an address by W. M. V. Ash, President of Shell Oil Co. of Canada, Ltd., to The Controllers Institute of America, Toronto.

Depreciation and Taxes - Theory and Practice

EDWARD W. NETTEN

OF THE FOURTEEN bulletins which have been issued by the Committee on Accounting and Auditing Research of the C.I.C.A., Bulletin No. 10 which deals with the relationships of depreciation, capital cost allowances and income taxes is probably the most interesting and certainly the most controversial. The other bulletins have merely restated or clarified established accounting principles, whereas Bulletin No. 10 sets forth a principle which was new to Canadian accountants. The profession in the United States and England had previously faced problems similar to those dealt with in this bulletin, and they arrived at conclusions which differed considerably from each other's and from those reached by the C.I.C.A. committee. It will be very educational to see in future years whether the divergent views can be reconciled and whose views come to predominate.

The Problem

The problem of allocating income taxes arises where there are material items entering into the computation of taxable income which are not included in the earnings statement, or vice versa. Such an item is the excess of capital cost allowances claimed for tax purposes over the depreciation recorded for the year.

In 1954 the federal income tax regulation 1100(4), which limited corporate capital cost allowances to the depreciation charged in the books, was revoked. Companies thus became free to determine annual depreciation in accordance with accepted principles without suffering tax penalties from so doing. Many companies which had charged maximum capital cost allowances in their books then reverted to a straight-line or modified diminishing-balance basis, predicated on the expected useful life of the assets. However, they claimed maximum capital cost allowances for tax purposes, which in many cases substantially exceeded the depreciation, and therefore reduced the tax payable for the year. These excesses were brought about by differences in rates and by claiming capital cost allowances on assets under construction and on assets coming into service late in the year.

If the tax reduction affected the results of the current year only, there would be no problem of income measurement. For example, no problem is raised by items such as non-

taxable income, disallowed bond discount or tax allowances for depletion not recorded on the books. In these cases the disparity between taxable income and profits is consistently present year after year.

However, in the long run, recorded depreciation will usually correspond to the aggregate capital cost allowances claimed. If the allowances are greater than depreciation in any one year they will be less in some future year. In these circumstances income taxes payable will be less in earlier years and greater in later years than if based on the profits recorded in the accounts. When capital costs are utilized for purposes of tax reductions in one year, less remains to be so utilized in future years. If the resulting, often irregular, variation in taxes is reflected in yearly profit figures, the reported profits and their comparisons with other years can be very misleading.

Because the amount of net profit after taxes is considered significant by shareholders, such variations, if material, should be eliminated from reported earnings or at least disclosed.

Solutions to the Problem

There are a number of schools of thought as to the best manner in which the problem should be handled:

1. The deferred credit method.
2. The deferred liability method.
3. The additional depreciation, equal to the tax reduction, method.
4. The segregated surplus method.
5. Disclosure by a note.

All of these treatments, except that of disclosure by a note, eliminate from earnings the tax reduction derived from claiming additional capital cost allowances. They accept the principle of allocation of income taxes.

Financial statements are based on allocations of receipts, payments, accruals and other items. The proponents of the first four treatments feel that income taxes are an expense that should be allocated, where necessary and practical, to earnings or other accounts in the same manner as other expenses are allocated. The earnings statement should reflect for income taxes, as in the case of any other expense, the expense properly allocable to the income reflected in the earnings statement for the year. The profit will then more nearly reflect the result of a proper matching of costs and income in measuring business profits.

Deferred Credit Method

The C.I.C.A. committee recommends the deferred credit method as the most practical means of recognizing the receipt of a current benefit for tax purposes which is to be applied to income measurement only when the corresponding charge is made in the accounts as depreciation. It considers that a material reduction of current taxes, resulting from claiming capital cost allowances in excess of recorded depreciation, should be treated as a deferred credit applicable to those future years in which depreciation corresponding to the excess is charged in the accounts, rather than reflecting such reduction in the reported net profit of the current year.

It is to be emphasized that the deferred credit is not a provision for a future tax liability but rather a benefit to be brought into income measurement in later years, if and when

recorded depreciation is greater than the capital cost allowances. As such it need not be adjusted to reflect subsequent changes in tax rates or possible future changes in methods of making tax allowances for depreciable property.

Under this method, two tax elements are shown in the earnings statement:

1. A charge for the tax actually payable for the year.
2. A charge for the amount by which taxes have been reduced (or a credit if the taxes have been increased).

The total of these two items will be the amount of taxes that would have been payable if the allowances claimed for tax purposes had been the same as book depreciation.

In later years when recorded depreciation is more than the capital cost allowances, a transfer from the deferred credit account is made to earnings to offset the taxes otherwise payable for the year. The amount transferred is calculated by applying the effective average rate of tax in the years of accumulation to the excess of current book depreciation over current capital cost allowances.

In a year of loss where additional capital cost allowances increase the tax carry-back recovery, the extra recovery should be viewed not as a decrease in the current loss but as a benefit to be deferred to future years.

No change of principle is necessary where the depreciation exceeds the capital cost allowances in a year of loss. The tax reduction effected in previous years is applicable when the depreciation is recorded, even if that is a year of loss, and may be brought into the earnings statement as a credit.

Deferred Liability Method

The Committee on Auditing Procedures of the American Institute favours the deferred liability method of presentation. Under this method provision is made for the additional taxes which may be payable if book depreciation exceeds tax depreciation in the future. The effect on profits is similar to that of the deferred credit basis. The balance sheet item, however, is considered to be provision for a future tax liability rather than a deferred credit. The American Institute's committee considers that the tax reduction need not be recognized in the accounts unless it is reasonably certain that the reduction during the early years of asset use is merely a deferment of taxes until a relatively few years later, and then only if the amounts are clearly material. Where replacements of depreciable assets take place regularly or where there is a gradual expansion of physical facilities, payment of the accumulated tax liability may be postponed indefinitely, and so in this case the committee feels that no accounting recognition of the current tax reduction is desirable.

Additional Depreciation Method

The American Institute committee has set forth an alternative treatment to that of recognizing the deferred tax liability. It suggests that an amount equal to the tax reduction be charged as additional depreciation and credited to accumulated depreciation, as a means of allowing for the loss of future deductibility of the capital cost for income tax purposes. The effect on the net profit is the same as under the deferred credit method. Fixed assets develop expense charges (through deprecia-

tion) and also expense savings (through income tax reduction), and it is reasonable that the charge and the saving should be related in time. This method recognizes in the balance sheet the loss of value resulting from exhausting the claims for future capital cost allowances. It avoids the possibility of a constantly increasing deferred credit in the case of a company which continuously replaces or expands its property assets.

Segregated Surplus Method

Because the current tax reduction does not establish an immediate liability for taxes, some accountants believe that the tax reduction should be carried in the shareholders' equity section of the balance sheet as an equalization reserve to compensate for unrealistic fluctuations in profits until it is utilized to reduce the charge against income for taxes in later years.

As a matter of interest, it is the practice of some firms in England to set up a tax equalization reserve, approximately equivalent to the current tax reduction, by a charge against profits, which is shown on the balance sheet as a surplus reserve or a deferred tax reserve. The annual tax reduction is computed by comparing the net book value of depreciable assets with the undepreciated capital cost, calculating the tax on the difference at current rates, and deducting the amounts previously set up. The comparison of net asset amounts is more logical than the comparison of depreciation because it allows for prior years' differences and for repairs and replacements capitalized by the tax authorities.

To bring the tax reduction into the shareholders' equity section is to bring it into surplus. This is a contradiction of the charge against income. C.I.C.A. Bulletin No. 9 suggests that the word "reserves" be limited to segregations of surplus and designates reserves as amounts appropriated from net profit or other surplus. This method gives the anomaly of reducing profits and then using the reduction to increase surplus.

Disclosure by a Note

The C.I.C.A. committee recognized the diversity of opinions and therefore approved, as a less desirable alternative to the deferred credit method, reporting the net profit as the amount determined after charging as income taxes the amount actually payable for the year, provided that the effect of the tax reduction on the net profit and the net accumulation of such reductions are disclosed by an explanatory footnote on the financial statements.

When reported profits are based on the taxes actually payable, the profits may be altered at will according to management decisions as to the amount of allowances to be claimed.

A footnote may raise doubts as to whether it is merely an explanation of the basis on which the net profit has been determined or is an adjustment or qualification of the reported profits. It may also be construed as of minor importance or as indicating a difference of opinion between the directors and auditors. Generally it is undesirable to offer the shareholder an alternate computation of profits.

Many accountants favour the note method because they feel that a deferred credit may never be utilized. They accept that the deferred credit argument is valid for a single asset,

but argue that in a dynamic multi-assets company, which regularly replaces or expands its facilities, a large credit may be built up which would only be reduced during a period of contraction or liquidation. Because of an assumed growth, or at least maintenance, of fixed assets, the credit may never be restored to income. Indefinite postponement is thus equated to a real saving.

On the strength of this argument, British American Oil, Canadian Industries Limited and Molson's Brewery in 1956 reversed their previous policy of reflecting the tax reductions as a deferred credit. However, there are objections to the argument for the reasons discussed below.

1. Similar items such as unearned finance charges are not ignored merely because the company is growing and the amount can be expected to increase.
2. The rate of fixed asset acquisition is a matter of great uncertainty, and may be sporadic or occur at infrequent intervals in large units.
3. The accumulated tax reductions need not be considered as a pool, but rather as applicable to individual assets. The reductions are continuously turning over, the earlier credits being gradually exhausted and new ones arising as additional assets are acquired.
4. Looking at a group of assets the tax reductions cannot be considered as a real saving in the light of the difference in price which a purchaser is prepared to pay for fixed assets as opposed to acquiring the assets through the purchase of shares where there are substantial differences between the resulting capital cost allowances. One of the most important considerations in determining the value of fixed assets is the tax reductions they can create. Allowance must be made in arriving at profits for the loss of asset value due to exhausing tax allowances. At today's tax rates almost one-half of the cost of depreciable assets is being paid for by the government through allowances against taxable income. The exhaustion of these claims should be considered a proper income charge even though it is not a cash outlay.

An incidental point is that where the tax reduction is deferred the reported profits will be lower in a time of expansion and higher in a period of contraction and depression. This tends to show more even profits over a long period of time, smoothing out the peaks and valleys.

Thus, there are at least five different treatments available for handling the tax reduction, all of which have support in some quarters.

Statistics of Use

A review by the Research Department of the C.I.C.A. of 287 published reports for 1955 shows the extent to which each of the five methods is supported in Canada. Some 70% of the reports made no mention of the depreciation or tax bases used; presumably book and tax depreciation were substantially the same. About 8% indicated that recorded and tax depreciation are the same. Of the remaining 22% about one-fourth set up a deferred credit, one-fourth a deferred tax liability and one-half disclosed the position by a note. Many of Canada's leading companies have adopted the policy of deferring the tax reduction to future years.

The Research Department found no cases where the additional depreciation method was used, or where the tax reduction was shown in the shareholders' equity section of the balance sheet. However, the writer has seen one printed report in which the reduction was shown in the equity section. Another report did not defer the tax reduction because the excess capital cost allowances were offset by excess book depreciation at some time in the past.

The accountancy profession has arrived at varying answers to the problem of the inter-relationship of depreciation and income taxes. It is to be hoped that eventually a substantial degree of uniformity will be achieved.

SECRETS OF SUCCESS

In a satirical short story written more than 200 years ago, the Chinese scholar, P'u Sungling, told how a young man who had intended to devote his life to study was induced to forsake his ivory tower and become a political success.

As may be guessed, a beautiful young girl played a part in the story, acting both as the young man's temptress and as his teacher. Many of the lessons were on learning what to say. The lower grades of this art were for the student to say what was not on his mind and to say what was on the mind of the person he was speaking to.

However, these arts, while undeniably useful, led only to positions in the lower grades of the Chinese civil service. The highest art, perfection in which led to posts of the highest rank, those of governors and ministers and prime ministers, was to learn to say half of what was on his mind. Perfection in this art was attained when the political aspirant could never be caught affirming or denying anything, "and when things turned out not to be what he had thought at first, he could always conveniently deny what he had affirmed and affirm what he had denied."

— From *The Printed Word*, November, 1957.

Edited by LAWRENCE G. MACPHERSON, F.C.A.

Accounting Research

Director of Research, C.I.C.A.

INVENTORY AND LIABILITY CERTIFICATES

Readers of these columns will recall the forms of inventory certificate and liability certificate which were designed by the Committee on Accounting and Auditing Research, and published in *The Canadian Chartered Accountant*, September, 1956 (pp. 245, 247). In response to requests from practising chartered accountants, copies of these forms in English and French are now available for use, and may be purchased from the Institute, in quantities of 50 or more, at $1.00 per package of 50 of either certificate. For the present, blank forms only will be available.

THE AMSTERDAM CONFERENCE

Editor's Note: To give our readers a report on the business proceedings and social activities connected with the Seventh International Congress of Accountants, the Editors asked Lawrence G. Macpherson, F.C.A., who attended in his capacity as C.I.C.A. Director of Research, to undertake this task. Here is his report.

While, inevitably, individual impressions of the Seventh International Congress of Accountants must vary, one thing is certain; all those who attended came away with a broadened outlook and a new appreciation of the common bond which disregards international boundary lines.

The delegates also brought away with them a new feeling of enthusiasm and inspiration and an added insight into the effect of national environment on accounting and auditing problems.

The entire program throughout the 5-day congress was skilfully planned and organized with a happy blending of the formal and informal in the technical sessions and social affairs. Organization of the congress must have been a mammoth task. Over 1,600 accountants, many with their ladies, were registered. Seven hundred of the participants were members of the two sponsoring bodies, the Netherlands Institute of Accountants and the Association of University Trained Accountants, and the remaining 900 came from 35 other countries. Some 70 national accounting bodies were represented as well as several state societies and provincial institutes.

Accommodation for visitors was reserved in 46 hotels in Amsterdam and 13 hotels in nearby towns. As in most cities, the problem of housing such a large number of guests could be solved only by using a variety of facilities, from plain to deluxe.

This is not the place to describe in detail the technical papers presented

at the congress, since they will be discussed in other articles, but a broad outline of the program and procedures may be given.

There were six business sessions during the five days of the conference, in addition to the opening session on Monday, September 9, and the closing session on Friday, September 13, The theme of the conference was eloquently expressed by His Royal Highness the Prince of the Netherlands, who, in opening the congress, said: "The real significance of professional congresses like yours is, I feel, primarily to be seen in the usefulness of open-minded discussion of the many problems which must face you. However, a not less interesting objective can be attained by assemblies like this. International congresses, which provide opportunities for a down-to-earth discussion of professional problems as well as real personal contact between representatives of many nations, can do much towards promoting a better understanding. And this, in its turn, goes a long way towards respect for and appreciation of opinions and a way of life differing from our own. . . .

"A profession like yours. which in particular occupies itself with economic and financial matters, is peculiarly susceptible to the danger of materialism. You do not need a warning against this as you have decided to start your proceedings with a discussion on the principles of your profession."

The program of the technical sessions was well balanced between principles and practice both for accountants in practice and for accountants in administration. Six topics were discussed:

1. Principles for the accountant's profession.
2. Budgeting and the modernization of accounting.
3. The verification of the existence of assets.
4. Business organization and the public accountant.
5. The internal auditor.
6. Ascertainment of profit in business.

For each of the technical sessions, five or six papers had been prepared, printed and distributed to all registrants before the opening of the congress. At each session, one of the authors presented a 20-minute summary of the prepared papers and this was followed by discussion of the subject by a panel consisting of those who had written papers and three or four other members. The Canadian Institute of Chartered Accountants was represented in this part of the program by J. A. de Lalanne (The Verification of the Existence of Assets), W. L. L. McDonald (Principles for the Accountant's Profession), and L. G. Macpherson (The Internal Auditor).

The planning of panel discussions in which as many as four different languages, English, Dutch, French and German, might be spoken, must have taxed the ingenuity of the Congress Committee, but the results proved that the committee was fully equal to the demands on its skill and imagination. At each session, everyone had a choice of simultaneous translation into English, French and German, which was made possible by the use of broadcasting booths for the translators and "walkie-talkie" receivers for the listeners. The system worked well, with only occasional difficulties due to electrical interference, translation gaps, or battery exhaustion.

As each of the technical sessions was two hours long, they can be summarized only in a general way.

The panel on principles for the accountant's profession concentrated on the responsibilities of the accountant. The discussion leader pointed out that this is an emphasis not found in the other professions where the members' responsibilities are taken for granted, either because they have been long-established or because the responsibilities in those professions are more easily defined. By general agreement three basic principles were assumed for the accountant's responsibility: honesty, independence and knowledge. The quality of independence is peculiar to the accounting profession, but honesty and knowledge are surely basic to all professions.

The panel on budgeting held various viewpoints but seemed to reach a fair measure of agreement. Budgeting has not been fully assimilated into accounting thought, and there is much room for further discussion. The danger of overburdening management with masses of information must be recognized. Budget standards should be appropriate and attainable, not impossible ideals. Budgeting requires greater emphasis on replacement values than on historical cost. One member of the panel objected to this latter point of view fearing that it carried inflationary consequences.

Mr. J. A. de Lalanne, C.A., president of the Canadian Institute of Chartered Accountants, presented the summary of the papers written for the panel discussion on the verification of assets. (His own paper is published elsewhere in this issue.) His summary suggested general agreement by the authors on the following points:

1. "Stocktaking" in its broad sense is an essential part of any audit.
2. Personal inspection is generally the surest evidence of existence.
3. Surprise inspections will be found most effective for assets subject to ready substitution (e.g. merchandise, securities, cash).
4. The appropriate time, frequency and extent of inspection will depend on the size of the undertaking, the effectiveness of internal control and other pertinent factors.
5. Auditing competence does not ordinarily demand expert technical knowledge of the client's industry. Intelligent verification calls instead for reasonable care and skill combined with good judgment.

The panel debated whether the size of the concern or the standard of its organization is the determining factor in asset verification; the auditor's responsibility in countries where attendance of the auditor at physical stocktaking is the practice; and the need for emphasis on the economic significance of the stock in trade, in contrast to emphasis on mechanical test checking. Categorical answers to these questions could not be produced, since each audit engagement is a separate study whose solution depends on the mixture of factors involved.

As might be expected, the session on business organization and the public accountant could have been called "The Public Accountant and the Management Consultant". Should the auditor become a general business consultant, a consultant in management accounting, or a consulting

accountant associated with other specialists, such as engineers, lawyers, public relations experts, etc.? Or should he confine his attention to financial accounting? Canadian chartered accountants are familiar with this debate, and it may be comforting to know that the different viewpoints came no closer together at the International Congress than they do at our own conferences. Perhaps time will be the solvent which will ultimately produce the answers, and further discussions may speed the process. As one participant at the congress said: "A congress such as this one is not intended to provide answers, but to supply food for thought."

Most of the members of the panel on the internal auditor agreed that the basic function of the internal auditor is the protection of his company's assets, but the panel emphasized also the importance of a constructive approach to internal auditing The internal auditor should not, however, extend his "constructive" activities beyond the limits of his own capabilities.

The panel agreed that an attitude of independence was essential in internal auditing as well as in external auditing. Without that independence of mind, and the courage to present facts even when they may be in conflict with company policy, no auditor could claim professional qualifications. On the practical side, coordination and cooperation of the public accountant and the internal auditor were urged as the means of avoiding unnecessary duplication of work.

The most fundamental and difficult topic on the program was the ascertainment of profit in business, which was dealt with by a panel discussion on Friday, September 13. For some, the date was foreboding, for here, from a dozen different countries, distinguished accountants were critically examining the very foundations of accounting concepts and theory, and often suggesting that the traditional methods of income measurement had been tested and found wanting.

The conflict between hallowed "principles" and newer propositions was not resolved, but some felt less complacent about what they are doing, especially when it was learned that several large companies in Europe (for example, N. V. Philips' Gloeilampenfabrieken in the Netherlands) use some type of replacement value accounting in their annual reports. The Philips company applies indexes measuring the price variations of property, plant and equipment, to arrive at replacement value which provides the basis for depreciation allowances. The adoption of depreciation accounting on a replacement cost basis implies acceptance of the view that income should be measured as *the increase in capital which may be consumed without impairing productive capacity.* In a time of changing price levels, this measure of income is very different from the older, legalistic concept of income as *the increase in capital which is distributable,* and its implications for investors and for management call for further consideration by accountants. It is conceivable that neither of these views will ultimately prevail, but we cannot dismiss the problem by ignoring it.

The Congress Committee is to be congratulated not only on the excellence of the technical sessions but equally for the choice of the beautiful

Concertgebouw as a conference hall, and for the pleasure of the social affairs and entertainment which filled the leisure hours. The program included a formal dinner, an illuminated tour of the Amsterdam canals and harbour, a visit to the famous Rijksmuseum and an intriguing concert by the world-renowned Concertgebouw Orchestra. There was a delightful all-day tour through polder landscape, reclaimed over the past century, to the seat of government at The Hague, the seaside resort of Scheveningen, the miniature "city" of Madurodam, the university city of Leiden, the flower market at Aalsmeer. Finally the closing ball was directed with a masterly touch. The two sponsoring bodies and the Congress Committee under Mr. J. Kraayenhof, the president of the congress, and Professor A. M. van Rietschoten, vice president, earned the admiration and warm appreciation of the delegates, which was so ably expressed at the closing session by the president of the Canadian Institute of Chartered Accountants on behalf of all who attended.

BY JOHN W. CROWE, C.A.

Administrative Accounting

Own, "Lease-Back" or Rent?

In this world of tight money an interesting problem which is receiving more and more attention is whether a business should own its fixed assets outright, use one of the several "lease-back arrangements offered by financial institutions, or rent. While this question is probably most generally associated with the acquisition of new warehouses and office buildings, it can arise in regard to older assets and even be extended to operating assets such as stores and plants. The leasing of automobiles is a similar question.

To assess the financial aspects of the problem, let us take a practical example of a new warehouse based on construction costs and other data believed presently realistic in Eastern Canada.

It will be assumed that a new warehouse building costs $7 a square foot and new land required is estimated at an amount equivalent to $2 a square foot. Total original cost of a new warehouse building and land is, therefore, estimated at $9 a square foot.

A typical "lease-back" scheme would involve selling the warehouse building and land to an insurance or other financial company and "leasing it back" over 25 years with or without an option to repurchase at the end of that time. It is believed that the present going "rental" under such contracts to a company of reasonable credit risk is about 8.3% of the original cost per annum. With the option to repurchase, the terminal repurchase payment is, as a rule, approximately 5% of the original cost of the asset.

The straight rental going rate is estimated at $1.20 per square foot per annum. A rental charge includes certain expenses which must be paid separately in the case of both outright ownership and "lease-back". Such outlays are chiefly realty taxes, property insurance, and building maintenance and are estimated at 25c per square foot per annum. A fair rental figure for comparison with expenditures under ownership or "lease-back" is, therefore, 95c ($1.20 less 25c) a square foot per year.

Other warehouse expenses such as operating wages, stock insurance, etc. have to be incurred by the occupant whether he owns, leases or rents and can therefore be ignored as extraneous to this study.

The problem using the above example, which is considered typical, is to determine which method of acquiring warehouse facilities is cheapest to a company in the long run.

Cash Outlays Over 25 Years

Let us note the actual *net* cash outlays under each scheme over 25 years. For convenience, the effective rate of income taxes has been assumed to be 50%.

1. *Outright ownership*

There is the immediate acquisition cost of $9 per square foot. However.

capital cost allowances at, say, 5% per annum diminishing balance over 25 years on the building cost ($7 per square foot) will total $5 for a tax reduction (using 50%) of $2.50 per square foot over the period. The net outlay is, therefore, $6.50 over 25 years. Offsetting this, the company still has possession of the warehouse building and land. A conservative valuation of a brick building would be to assume 2½% depreciation per annum or about 60% over the period. This would leave a terminal value of (40% of $7) $2.80, for the building, and taking the land at original cost we have a total terminal valuation of $4.80 per square foot.

2. *"Lease-Back" with option to repurchase*

This arrangement would mean an annual payment of 75c (8.3% of $9) per square foot per year or a total of $18.75 per square foot over the period. With the option to repurchase, annual payments are disallowed as deductions from taxable income and treated as payments on a capital purchase (sec. 18(1)). Capital cost allowances over the period are estimated at $12 per square foot and resulting reductions in taxes at $6 per square foot. The net cash outlay over 25 years, accordingly, would be $12.75 per square foot. In addition the occupant has the option to purchase after 25 years for 45c per square foot (5% of $9) a warehouse valued above at $4.80 per square foot.

3. *"Lease-Back" with no option to repurchase*

As in 2. above, annual payments amount to 75c a square foot per year or $18.75 a square foot over the period. Since there is no option to repurchase these lease payments are allowed as rent for tax purposes. Net payments after taxes, therefore, total approximately $9.35 a square foot over 25 years. The occupant, of course, has no residual asset.

4. *Straight rental*

Annual rental payments on a comparable basis amount to 95c ($1.20 less taxes etc. of 25c) a square foot per annum or $23.75 a square foot for 25 years. Net cost after taxes over the period is approximately $11.90 a square foot.

A summary of the net cash outlays per square foot over 25 years, less estimated residual property value, of the different methods is as follows:

	Net cash outlay over 25 years less residual value
Immediate ownership	$ 1.70
"Lease-Back" with repurchase option	8.40
"Lease-back" with no option	9.35
Straight rental	11.90

Clearly this bald comparison ignores the time element of the different payments and receipts. Some are much more delayed than others. "Lease-back" and rental contracts are, in effect, means of borrowing money, and we must determine how much money has to cost, or be worth, to make any of these schemes attractive.

Present Values at Different Interest Rates

Table I summarizes the present values of the expenditures and receipts under the four schemes over 25 years at rates of interest (or alternative values of money) ranging from 0 to 8%. Since tax effects have been taken into the calculations these interest rates are automatically effective rates, i.e. net after taxes. The table can be constructed using

TABLE I

Present Values of Comparative Costs Per Square Foot Over 25 Years With Varying Interest Rates (Values of Money)

Value of Money (After Taxes)	*0%*	*3%*	*4%*	*4½%*	*5%*	*6%*	*7%*	*8%*
Immediate Purchase								
Initial Payments	$ 9.00	$ 9.00	$ 9.00	$ 9.00	$ 9.00	$ 9.00	$ 9.00	$ 9.00
Less: Tax reductions through capital cost allowance	(2.50)	(1.90)	(1.75)	(1.70)	(1.60)	(1.50)	(1.40)	(1.30)
Residual Value	(4.80)	(2.30)	(1.80)	(1.60)	(1.40)	(1.10)	(.90)	(.70)
Net Cost Over 25 Years	$ 1.70	$ 4.80	$ 5.45	$ 5.70	$ 600	$ 6.40	$ 6.70	$ 7.00
Lease-Back With Option to Repurchase								
Payments to Insurance Company	$18.75	$13.05	$11.70	$11.10	$10.60	$ 9.60	$ 8.75	$ 8.05
Less: Tax reductions through capital cost allowance	(6.00)	(4.50)	(4.15)	(4.00)	(3.85)	(3.55)	(3.30)	(3.10)
Residual Value (Less option price)	(4.35)	(2.10)	(1.65)	(1.45)	(1.30)	(1.00)	(.80)	(.65)
Net Cost Over 25 Years	$ 8.40	$ 6.45	$ 5.90	$ 5.65	$ 5.45	$ 5.05	$ 4.65	$ 4.30
Lease-Back With No Option to Repurchase								
Payments to Insurance Company (after taxes)	$ 9.35	$ 6.55	$ 5.85	$ 5.60	$ 5.30	$ 4.80	$ 4.40	$ 4.05
Straight Rental								
Rent (less realty taxes, insurance, maintenance, etc. and income taxes)	$11.90	$ 8.25	$ 7.40	$ 7.10	$ 6.75	$ 6.10	$ 5.55	$ 5.05

standard interest tables and relatively simple calculations.

It will be noted that the present value of the costs of immediate ownership increases as the rate of interest increases. This follows from the fact that the present value of the immediate payment of $9 a square foot remains unchanged regardless of the interest rate, while the present values of future tax credits due to capital cost allowances and of any residual value decline with advances in the rate of interest. The present value of the costs of the other schemes, since they all involve deferred payments, decline sharply as the interest rate increases.

With an interest rate of 4% (after taxes) it will be seen that the present value of the cost of outright ownership, amounting to $5.45 a square foot, is still the lowest of the four schemes. This means, in this example, that if money costs or is worth to a company 4% or less (after taxes) immediate ownership is financially preferable to a "lease-back" or rental arrangement. If money costs or is worth 4½% (after taxes) the present value of the costs of ownership and the two "lease-back" schemes are about the same. This means that the "lease-back" contracts are, in effect, means of borrowing money at about 4½% (after taxes) per annum. If money is worth more than this rate to the company, the "lease-back" deals have financial merit. While the "lease-back" with no repurchase option appears to be slightly more advantageous than having the option, a more optimistic view of residual property values would alter the comparison.

At 6% and above (after taxes) straight rental becomes more attractive than ownership. A rental contract in this example is therefore a method of borrowing money at approximately 6% (after taxes) per annum.

At higher rates of interest the financial advantage of "leasing-back" or renting (instead of owning) becomes increasingly marked.

Value of Money

Having ascertained the effective rates of interest involved in financing an asset such as a warehouse by a "lease-back" or rental contract, it is, of course, necessary to determine how much money is worth to the company concerned. Let us suppose that ample funds can be obtained by a debenture issue at around 6%. This means that the effective cost of money to the company after taxes is 3% per annum and, in this case, immediate outright ownership of the warehouse would be much the cheapest arrangement. However, another company might have somewhat restricted borrowing capacity and a pressing need or promising opportunity to expand its productive assets. In this event the relatively high cost of "lease-backs" or rentals might be economically justifiable.

Summary

"Lease-back" and rental contracts (in contrast with ownership) are means of borrowing money. In assessing the economic merits of "leasing-back" or renting, it is primarily essential to determine the effective rate of interest, compared with immediate ownership being charged in each scheme. In the above example the effective cost of a "lease-back" agreement is approximately 4½% after taxes per annum. This follows from the fact that, as shown on the table, the present values of costs after taxes of owning and "leasing-back" are about

the same at this rate of interest. Since the calculations are based on a tax rate of 50%, the interest cost before taxes for a "lease-back" in this example would be approximately 9% per annum. Similarly the effective cost of a rental contract can be seen from the table to be about 6% after taxes or 12% before taxes. Having regard for the cost of money from alternative sources or the rate of return possible in some other investment, a company must decide whether, in its particular circumstances, any of these contracts is worth the cost.

In making a financial comparison of owning, "leasing-back" or renting, there is no need to forecast costs such as operating labour and materials which are common to all methods. Maintenance costs, property taxes and insurance must be considered in the case of straight rental, but can be ignored in comparing ownership with the usual "lease-back" propositions.

When comparing ownership with a "lease-back" with no option to repurchase or with straight rental, an estimate of the residual value of the property must be made. In the example above, the residual value was estimated at something more than the undepreciated capital cost balance and in case of sale at this value some income tax would be payable. However, in view of the historical trend of property values, the estimate which assumes 2½% depreciation per year on the building is probably very conservative. In any case in assessing ownership against a "lease-back" contract with an option to repurchase the residual value of property can be ignored as a common factor. This, in effect, removes the need of estimating depreciation.

At any rate of interest the present value of "lease-back" costs will generally be lower than that of comparable rental costs. The rental charge normally includes the landlord's own financing costs plus an element of profit.

Factors other than purely financial may, of course, be very important in making a final decision. Probably most important among these is the desire for flexibility which in some circumstances weighs heavily in favour of renting regardless of cost. Such considerations, however, are beyond the scope of this article.

Addendum on Calculations

A formula which can be used in ascertaining the present value of capital cost allowances over a *number of future years* on a single asset is as follows:

$$\text{Original cost} \times \frac{r}{i + r}\left[1 - \frac{(1 - r)^n}{(1 + i)^n}\right]$$

r = rate of capital cost allowance (e.g. .05 for 5%),
i = rate of interest and n = number of years. The values of $\frac{1}{(1 + i)^n}$ can be obtained from standard interest tables.

The present value of all capital cost allowances on a single asset in *the long run* is given by the following simple formula:

$$\text{Original cost} \times \frac{r}{i + r}$$

The present values of constant annual payments and of residual values can, of course, be obtained from standard annuity and interest tables.

BY A. WILLARD HAMILTON, C.A.

Tax Review

More of the Nothings

(This is a continuation of last month's discussion of those expenditures which, while recognized under sound accounting practices, have been disallowed for tax purposes and hence are often referred to as "nothings".)

Losses on Loans, Advances, etc.

(a) *Accommodation loans to customers*

A company in the ship-chandlering business found it promoted business to make loans to its customers directly and through a subsidiary company. A loss of $5,000 was sustained in so doing. The deduction of that amount was disallowed because the lending was held to be merely incidental to the taxpayer's business activities and not an intrinsic part thereof. The form of lending was purely gratuitous accommodation rather than the business of lending money; no interest was collected. The loss was not a bad debt within the meaning of section 11(1)(f) of the Act.

(b) *Loss under guarantee of advances*

A taxpayer personally guaranteed bank advances made to a company in which he was interested. The assistance of the taxpayer helped the company very materially to maintain valuable connections with British manufacturers. The making good of his guarantee was determined not to have been an outlay or expense made for the purpose of producing his income.

(c) *Losses on logging advances*

Upon incorporation, a logging company acquired debts owing by a small operator who supplied lumber to it. Further non-interest-bearing advances were made and in 1951 $50,000 was written off and in 1953 an additional $100,000 was written off as bad debts. It appears that no serious attempts were made to collect the debts and a chattel mortgage security was not enforced. Consequently, the Court concluded that the amounts claimed had not been established to have become bad debts in the years stated. There is no indication in the judgment as to what the opinion would have been if proper evidence of non-collectibility had been forthcoming.

(d) *Shares in lieu of debt*

A taxpayer had two customers who were unable to settle their accounts receivable and he accepted preferred shares from both companies in lieu of settlement. Some two years later, losses aggregating $5,050 on the preferred shares were claimed on the ground that such losses constituted bad debts. The losses were determined to be non-deductible capital losses.

(e) *Sale of notes*

Heating and Plumbing Finance Limited, whose business was advancing money to plumbers to enable householders to improve their homes,

decided to wind up and sold the outstanding notes in its possession at a discount of $18,034, which discount was claimed as an expense. The deduction was disallowed on the grounds that it was not part of the taxpayer's usual business to trade in notes but that the sale of the notes was a sale of assets and the discount constituted a capital loss.

(f) *Partner's income tax*

One of the members of a partnership failed to pay his income tax, and his arrears were made good over a three-year period from the profits of other partners. The claim of one of these partners that the payments made good by him were a business expense was disallowed as not being a transaction within the frame-work of the partners' business but a transaction on account of capital.

(g) *Loan to company*

A chartered accountant undertook, for 50% of the profits, to finance and assist in the management of a small incorporated business. The taxpayer suffered a loss aggregating $12,482 when his loans went unpaid upon the cessation of business. He attempted to deduct this amount on the premise that he was in partnership with the company and the loss was a normal business loss. It was found that he was merely a creditor of the company and, while the suggestion of a partnership was an ingenious one, the loss was a capital loss.

(h) *Loss on oil company shares*

Because of a shortage of fuel oil in Ontario, the Robert Dixon Company Limited, which sold oil burning units, found it necessary to purchase $10,000 of the capital stock of an oil company to ensure a supply of oil for the customers who bought its oil burners. Two years later the oil company went bankrupt and the Dixon Company deducted the $10,000 as a cost of doing business. The deduction was denied as the shares bought represented a capital asset and ultimately a capital loss to the taxpayer.

Financial Expenditures

(a) *Bond discount*

The discount on an issue of bonds has always been recognized as a capital item and when section 11(1)(cb) was added to the Act in 1955, to allow certain expenses of issuing shares or borrowing money, a prohibition was included in subparagraph (iv) to exclude the discount on bonds or other indebtedness. The best method to avoid issuing bonds at a discount would appear to be to increase slightly the interest rate proposed so that the bonds can be sold at par or better.

(b) *Premium on redemptions*

Similarly, any premium paid on the redemption of bonds or other obligations is a capital expenditure and of no advantage taxwise.

(c) *Bonus to obtain mortgage*

A partnership in purchasing an hotel arranged for a first mortgage of $100,000 but later found that an additional $60,000 was required. Difficulty was encountered in arranging a second mortgage for the latter amount, but eventually funds on a five-year basis were secured at the cost of a $20,000 bonus. The partnership decided to write off $4,000 per annum, as representing an outlay or expense for the purpose of gaining income. The Minister's contention that the bonus was neither that type of expense nor interest on borrowing money, but rather a capital expendi-

ture, was accepted by the Income Tax Appeal Board.

(d) *Premium to discharge mortgage*

A taxpayer who purchased a property with a balance owing of some $15,000 undertook to pay $1,800 per annum for ten years by way of a first mortgage obligation. Having decided to make extensive alterations within a year, the taxpayer found that he could only discharge the mortgage by paying the full $18,000. He deducted the $3,000 as representing interest. The Income Tax Appeal Board held that the amount above $15,000 was a bonus payment of a capital nature to obtain release of an obligation.

(e) *Cost of guarantee*

Consolidated Leaf Tobacco Company Limited made payments of $3,653 to an investment company for guaranteeing bank loans so that the security for such loans, i.e. tobacco, could be released from the provisions of section 88 of the Bank Act and shipped to a warehouse in England. The outlay was held to have been on account of capital.

This decision followed the Supreme Court's dictum in *Bennett and White Construction Company Limited* where commissions of 6% paid to directors for guaranteeing substantial bank borrowings, which the company could not obtain on its own strength, were disallowed as expenditures incurred for the financing of the business as distinct from the activities by which the company earned its income.

Acquisition of Business, etc.

(a) *Expenses before incorporation*

Expenses totalling $4,395 made by a partnership prior to incorporation of the business were treated as prepaid expenses of the incorporated company and deducted in arriving at the taxable income for the first fiscal period. It was held that no one could properly act as the agent of a company before incorporation, and the company was not bound in equity to pay the preliminary expenses even though it derived benefit from the services performed. The deduction was disallowed.

(b) *Expenses before commencement of business*

It is also well established that expenses anterior to the commencement of operations such as legal expenses, incorporation fees and the like are not deductible for tax purposes.

(c) *Expenses to obtain agency*

The general agent for a Scandinavian steamship line made a trip to Denmark in the hope of obtaining an appointment as steamship agent for one or more companies and, secondly, to obtain capital to be invested in his business. He deducted one-third of his expenses of the trip as having been wholly, exclusively and necessarily laid out for the earning of income (Income War Tax Act). The deduction was disallowed as not having been so laid out but as having been in the nature of a preliminary expense made with a view to obtaining something liable to produce income.

(d) *Receivables of retired partner*

Four doctors had a partnership agreement, under the terms of which, in the event of death or retirement of a partner, instalment payments would be made, based on 50% of his share of the accounts receivables and his share of all other assets. Upon the retire-

ment of a doctor one of the continuing partners, deducted, as an expense, his share of the payment to the retired partner. It was held that the amount represented the purchase price of the retired partner's interest in the outstanding accounts receivables and was a capital outlay for the purchase of a capital asset.

(e) *Debts of predecessor*

A limited company purchased a business and undertaking known as "The Fiction Book Club", and, in taking over the assets, assumed certain liabilities which, after adjustment, amounted to $15,000. This total represented the cost of printing and mailing over $500,000 advertising folders previously ordered by the vendor and the cost of 11,296 books intended to be supplied free to those customers who joined his (the predecessor's) book club and agreed to purchase six books in a year.

In the opening balance sheet the expenditure was described as "deferred charges to future operations — deferred portion of cost of acquiring new members" — and the $15,000 was duly written off as representing an outlay or expense incurred for the purpose of producing income. The Income Tax Appeal Board held that the assumption of liability was virtually part of the purchase price of the business and no deduction could be taken by the purchaser, even though two chartered accountants testified that it was quite proper and, in their opinion, sound practice to treat the amounts paid as deductible disbursements within the relevant taxation period.

Sundry Assets

(a) *Land—for new building*

The taxpayer purchased land, on which an old building was situated, for a price of $30,000. After several unsuccessful attempts at renting, the building was demolished and a claim made for demolition costs and for the terminal loss on the demolished buildings in its 1952 tax return. The Income Tax Appeal Board disallowed the deduction on the basis that, while the intention may have been to rent the building, the purchase was made primarily because of the value of the land and hence the loss was a capital loss.

A somewhat similar set of circumstances was present in *re Ben's Limited* where adjacent properties were acquired and the houses thereon removed to provide room for factory extension. The Exchequer Court of Canada, confirming the Appeal Board, reached the conclusion that the purchase was for the sole purpose of acquiring a larger site and was, therefore, a capital expenditure. The receipt of a few months rent was merely a fortuitous event.

(b) *Golf course*

In dealing with the claim for capital cost allowances on the cost of building a miniature golf course for night-time commercial operation, it was found that the sodding of the green and fairways was not subject to capital cost allowance, because of the prohibition in class 8(b) which excludes "a tree, shrub, herb or similar growing thing". Similarly grading costs and architect's fees relating to grading were excluded. In this case the regulations appear too restrictive, because the life of such a venture is generally relatively short and it is most unlikely that there would be much salvage value if the project were to be abandoned.

(c) *Breaking farm land*

The Income Tax Appeal Board has determined that the cost of "brushing" and "breaking" farm land was a capital expenditure to place the farmer in the position of earning additional income from his farm in subsequent years.

(d) *Goodwill*

It has always been recognized that the purchase of goodwill, being an expenditure for the enduring benefit of the trade, is a capital item and that no amortization is possible for tax purposes.

(e) *Trade mark registration*

Fees and expenses for registering such intangible assets as trade marks are expenditures of a capital nature and as such of no advantage for tax purposes. It should be noted, however, that licences, franchises, concessions, etc. for a *limited* period are subject to capital cost allowances under the provisions of class 14 of Schedule B of the Income Tax Regulations.

(f) *Sulphur drilling costs*

A corporation engaged in the business of creosoting and the sale of building materials made an arrangement with three other corporations to explore for sulphur, a new endeavour. No sulphur was found and the expenditure in excess of $100,000 was disallowed as not having been made in the earning of profits, but in the hope of acquiring an asset or assets to make possible the earning of profits as a consequence.

Miscellaneous Expenses

(a) *Terminal audit*

The expense of an audit of the affairs of a partnership at the end of its 16 years of existence, for the purpose of ascertaining the respective interests of the partners, was disallowed on the grounds that it was not an expense of earning income. It was indicated, however, that had annual audits taken place during the life of the partnership, the costs thereof would have been accepted as normal business expenses for tax purposes.

(b) *Expenses of subsidiary companies*

Because of certain franchise arrangements under licence from the United States, the Canadian Ice Machine Company incorporated two subsidiary companies to carry on related lines of business. It contributed funds to the subsidiary companies to be used in advertising, sales promotional work and for sundry expenses. The deduction of these contributions was claimed on the grounds that financial benefit would accrue to it through the sharing of overhead and management expenses with the subsidiaries. As inter-company sales were made at cost there was no evidence of a profit accruing to Canadian Ice Machine Company. The appeal was dismissed on the finding that the expenditure was not directly related to the earning of income of the taxpayer. Mention was made of the fact that "It must be kept in mind that the appellant company and its subsidiaries are three legal separate entities".

(c) *Transfer fees—stock exchange membership*

The Minister disallowed as a deduction the sum of $1,000 paid by a stock brokerage firm, representing the cost of the entrance fee for one of its members to the Montreal Stock Exchange. The chairman of the Income

Tax Appeal Board could see no difference between a payment made for the purchase of a seat on the exchange and the fee to transfer the seat to the name of another partner, and upheld the Minister.

While an expenditure of this nature does not normally recur often, it is not unusual to find periodic reassignments of duties of the partners of a stock brokerage firm, involving a change in the member named to the Exchange.

(d) *Misappropriation by manager*

A general manager who was in complete charge of the affairs of a company converted some $36,000 to his own use. The Income Tax Appeal Board held that his action was the improper exercise of the control that he possessed and had nothing to do with the conduct of the company's income earning activities.

It was indicated that misappropriation such as "purloinings by office boys and thefts by shop employees" should be allowed as deductions.

(e) *Post graduate studies*

A medical practitioner who spent $200 for tuition fees covering a post graduate course claimed the expense as being wholly, exclusively and necessarily expended to earn income (Income War Tax Act). The payment was held to have been made once and for all and that the knowledge gained was as much a capital asset as the knowledge gained when he took his original medical course.

(f) *Political contributions*

The position with respect to contributions toward election expenses was explained by a former Minister of National Revenue in these words:

> Political contributions can be made. The donor of those pays the tax, and they are not deductible expenses in his hands, nor are they revenue if they go through the proper channels to the person who receives them.

(g) *Partners' life insurance*

The premium for life insurance policies which partners take on the lives of each other are not considered to be expenditures for the earning of income and are disallowed for tax purposes. If a claim results the proceeds of the policy are considered to be a capital receipt.

(h) *Wife as partner*

The Income Tax Appeal Board in the case of *Walter Klamzuski* was of the opinion that a bona fide partnership between husband and wife existed but found itself powerless to interfere with the discretion of the Minister to treat all of the income as being that of the husband under the provision of section 31(1) of the Income War Tax Act. Section 21(4) of the Income Tax Act has the same effect and was similarly applied in the case of *Max Margolis.*

(i) *Interest on income tax*

Notwithstanding the fact that any statutory interest paid at the rate of 2% on overpayments of tax is treated as income to the recipient, the Department of National Revenue has never permitted the deduction of interest paid on arrears or deficiencies of income tax on the basis that such is not an expense laid out for the purpose of earning income.

(j) *Fines and penalties*

Fines and penalties for breaking the law are not deemed to be deductible expenses, although as a matter of administrative convenience minor items like tickets for traffic violations are not normally disallowed.

BY PETER C. BRIANT, B.COM., C.A.

Current Reading

MAGAZINE ARTICLES

ACCOUNTING

"Whole-Dollar Accounting", published by the Controllership Foundation, Inc., New York; $7.50.

A new research report dealing with work-simplification and related techniques applied to accounting operations has been released by the Controllership Foundation, according to a report in *The Controller,* October, 1957.

The study is said to have an analytical chapter which provides a summing up and a general analysis of the Foundation's research on whole-dollar accounting and business experience in using it.

Major topics in the analytical chapter include: a description of whole-dollar accounting; an appraisal of the results of research into the subject and a recommendation based on results; a summary listing the advantages of whole-dollar accounting as well as its limitations; and an illustrative exposition of the advantages and limitations.

The study is also reported to contain, in addition, 13 case studies of the experience with whole-dollar accounting plus appendixes supplying materials pertinent to the subject.

Copies may be obtained from the "Controllership Foundation, Inc.," Two Park Ave., New York 16, N.Y.

ECONOMICS

"Are Prosperity and Stable Prices Incompatible?" by Carroll M. Shanks; published by The Economic Club of Detroit; pp. 13.

Accounting literature over the past ten years has exhibited a great concern on the part of accountants with the problem of adjusting the accounts to allow for the instability of the monetary unit. It is to be hoped, however, that the majority of accountants are equally interested in the compatibility of prosperity and stable prices, which is the subject of this address to The Economic Club of Detroit.

Carroll M. Shanks, an insurance company executive, is by no means prepared to accept the view that the debasement of the currency is a necessary concomitant of the dynamic, full-employment economy. On the contrary, he suggests in this pamphlet a positive seven-point program designed to stabilize aggregate demand and aggregate supply at a level of economic activity compatible with a relatively stable price level.

A flexible monetary policy, a fiscal policy that complements monetary policy, and a program to increase savings – these are the tools the author believes should be used intelligently to contain aggregate demand within non-inflationary limits. To call a halt to the recurring wage-price spiral on the supply side, he advocates: a steady abandonment of all government price support programs; more effective efforts to increase competi-

tion in the economy; and a rediscovery of the advantages of intelligent price competition. Finally, Mr. Shanks would have all members of the community made more aware of the sinister influences of inflation than they are at present.

The most important message contained in this booklet is the reminder that there will always be periods of adjustment in the economy, but that all adjustments do not have to be effected through the price mechanism. At times, warns the author, we must be willing to accept short periods of temporary rise in unemployment in order to ensure stable prices.

EDUCATION

"STUDENTS' SECTION," by R. W. Robertson. *The Australian Accountant*, July 1957, pp. 319-321.

In the introduction to an article entitled "What is Accounting?", Mr. Robertson makes the following observation:

> From my own experience and a study of examiners' reports, I have reached the conclusion that many candidates for the Society's examinations do not understand just what accounting is, or what its purpose is. Obviously this lack of understanding must be a serious handicap to students in dealing with accounting problems . . .

While Mr. Robertson has probably taken an overly pessimistic view of the situation, his remarks should serve as a warning to us that some of our own students may also be suffering from this same lamentable deficiency.

"SUCCESS ON THE CPA EXAMINATION —PRODUCT OF CLASSROOM OR PRACTICE?" by Harry Simons. *The Accounting Review*, October 1957, pp. 605-611.

The place of practical experience in the education and training of a professional accountant is a topic that will doubtless continue to be debated for many years to come. Professor Simons' contribution to the literature on the subject consists of a statistical analysis of the examination results of 253 graduates of the School of Business Administration, University of California at Los Angeles. The data covers a seven-year period and includes only those students who attempted the American CPA examinations solely on the basis of their accounting education at the university.

Generalizations on the basis of such a limited sample are dangerous; furthermore, conclusions based on American data may not hold true in Canada. Nevertheless, members interested in the problem of education for the profession should consider seriously the implication of this article: it lends factual support to the majority view expressed in the recent American report that practical accounting experience should be acquired by a university graduate *after* rather than before he has successfully passed the professional examinations.

Simons' figures leave no doubt that candidates lacking practical experience encounter most difficulty in the auditing examination. But he finds that the added advantage of practical experience in this direction is more than outweighed by the loss of previously acquired accounting knowledge suffered by students who attempt to combine full-time practice with concurrent part-time studies; only the rare individual, he asserts, can successfully engage in such a program. In his opinion, the majority would benefit more from attemping the examinations as soon after graduation as possible, making up later for their deficiencies in auditing.

INTERNAL AUDITING

"STATEMENT OF RESPONSIBILITIES OF THE INTERNAL AUDITOR"; published by the Institute of Internal Auditors, 1957.

This revision of the 1947 statement has been prepared to present a statement incorporating the advanced conception of the nature, scope, and responsibility of the internal auditor today.

Internal auditing is now said to be "a managerial control" rather than "a type of control". The expanded scope of internal auditing is formally recognized in the statement that its overall objective is to assist "all members of management in the effective discharge of their responsibilities" and in the advice that the internal auditor "should be concerned with any phase of business activity wherein he can be of service to management".

MANAGEMENT SERVICES

"MANAGEMENT SERVICES — A CHALLENGE TO THE PROFESSION" by Roger Wellington. *The Journal of Accountancy*, October 1957, pp. 54-58.

Management consulting requires a much broader approach on the part of accountants than does external auditing, according to the chairman of the American Institute's committee on management services. The financial facts and figures must be approached from the point of view of their practical usefulness to management in coping with its problems, rather than as a means of protecting the business and complying with legal requirements. Auditors who engage in management services are admonished to sit back and reflect on their clients' operations as a whole, to avoid a narrow technical approach to the accounts, and to think of the real factors that lie behind the figures.

One may infer from Mr. Wellington's remarks that an auditor, no matter how competent he may be, will not make a successful management accountant unless he is able to appreciate the viewpoint and needs of business management. A recognition that the most important function of business records is to supply information for management, he considers to be essential to this end.

"MANAGEMENT SERVICES AND THE ACCOUNTING PROFESSION" by Charles Lawrence. *The New York Certified Public Accountant*, October 1957, pp. 671-676.

Two recent pronouncements by the American Institute of Certified Public Accountants on the subject of management services make it necessary for accountants to define carefully the boundaries of their profession, asserts Professor Charles Lawrence of Michigan State University. A failure to do so, he writes, may ultimately lead to a loss of public confidence; particularly when the profession professes to offer a good many more services than accountants, *as accountants,* are competently able, on the basis of their training and experience, to perform. At the present time, Lawrence doubts whether the training of a professional accountant is sufficient to equip him to handle the diversity of problems classified by the American Institute as "management services".

Some large firms are adequately staffed with engineers, psychologists, and other specialists to perform the variety of services offered. But a continuation of this practice, warns the author, will lead to a two-class profession: a senior division compris-

ing firms with staffs large enough to offer coverage in all the suggested areas of management accounting; a junior division, with small staffs unable to provide adequate coverage. A tendency in this direction, it may be noted, is in evidence in Canada today.

An even more serious problem created by the employment of specialists in non-accounting areas by professional accounting firms is mentioned. The fact that such experts cannot be promoted to the highest echelons of their firms is sufficient proof to Professor Lawrence that they are not practising accounting. To call a firm whose members are experts drawn from various non-accounting fields, and thus unable to become partners, an accounting firm constitutes, says Lawrence, a denial of the validity of the present concept of specialized training for the professional practice of accounting.

MARKETING

"THE ACCOUNTANT'S IMPORTANT ROLE IN MARKETING" by J. C. Barnes. *The Australian Accountant*, June 1957, pp. 290-295.

The writer of this article, an accountant who has risen to the position of general manager in his company, has come to believe that accountants generally do not understand marketing as thoroughly as they should. In his opinion, this lack of knowledge prevents their contributing as fully to the success of their companies as they would if they were to realize the important role they can take in the marketing field.

This article details how the accountants' special skill can be utilized to best advantage through an understanding of such marketing problems as promotion, packaging, pricing, and branding, etc.

BOOK REVIEW

The Canadian Oxford Desk Atlas of the World. Edited by Professor E. G. Pleva and Spencer Inch. Oxford University Press; 103 pages; $3.95

The compact world atlas, in addition to 29 pages devoted entirely to Canada, and highlighting topic maps on minerals, industry, communications etc., also features complete world coverage. Special maps show world air routes in 1957 and the critical area of the Middle East. Recommended reading at any time, this work would make an ideal gift for this season of the year.

SHORTER NOTES

"ORGANIZATION AND FUNCTION OF INTERNAL AUDITING IN A MAJOR OIL PRODUCING COMPANY" by M. E. Price. *The Internal Auditor*, September 1957, pp. 29-35.

The author provides a useful case-study of internal audit objectives and methods in a large oil-producing company whose operations are conducted in 19 states, 3 Canadian provinces, and 2 islands in the West Indies.

"STUDY OF A SUCCESSFUL COMPUTER SYSTEM" by Paul Kircher. *The Journal of Accountancy*, October 1957, pp. 59-65.

A detailed report on the installation of a computer system in an insurance company to handle routines promising the greatest potential for savings. The narrative traces the selection of equipment and personnel through program preparation and final operation.

"A FLEXIBLE COST BASIS FOR PRICING" by A. H. Seed. *NAA Bulletin*, September 1957, pp. 5-12.

This article describes a way of relating costs and selling prices of products, and distinguishes between fixed and variable costs for pricing purposes. Market factors in price setting are also taken into account.

"MONTHLY DEPARTMENTAL RESULTS — WE GET THEM FROM OUR COMPUTER" by D. J. Coppotelli. *NAA Bulletin*, September 1957, pp. 55-61.

The author relates how a large company in the electrical manufacturing field obtains summary as well as detail reports from its computer application.

"THE CONTROLLERSHIP PROGRAM OF THE POST OFFICE DEPARTMENT" by L. H. Noble. *The Federal Accountant*, September 1957, pp. 7-24.

The deputy assistant postmaster-general and controller of the United States Post Office Department describes in some detail how, in his department, the entire controllership function, which represents only a part of the entire management reorganization program established to provide better service at a lower cost, has been strengthened through decentralization. Improvements in financial management, cost accounting and budgeting procedures designed to strengthen management throughout the Department are also revealed.

"CALCULATING ECONOMIC MANUFACTURING QUANTITIES FOR BETTER INVENTORY CONTROL" by W. J. Briggs. *NAA. Bulletin*, October 1957, pp. 57-64.

A case study under a hypothetical name, this paper explains a practical application of a formula approach to production lot determination.

"SOME PARTICULAR ASPECTS OF BUDGETING AS APPLIED TO A LARGE MERCHANT ORGANIZATION" by C. J. Hammond. *The Chartered Accountant in Australia*, June 20, 1957, pp. 685-696.

The author of this paper presents some important and practical aspects associated with budgeting procedures in a large department store. Four budgets are examined in detail: financial structure budget, sales and stock budget, profit and loss budget, and cash budget.

"RATES OF RETURN: THE EFFECTS OF BORROWING" by Louis O. Foster. *The Controller*, August, 1957, pp. 375-378.

An elementary analysis of the leverage produced by, and the risks involved in, debt and preferred stock in the capital structure. A suggested form of balance sheet classifies equities on the basis of the price to be paid for their use, distinguishing between non-explicit interest-bearing debt, explicit interest-bearing debt, prior dividend cost and common stock equity. A "new" income statement identifies the return available to each class of capital supplier.

An excellent article for students; should be common knowledge to practitioners.

Publishers' Addresses

Accountancy (Eng.), Incorporated Accountants' Hall, Temple Place, Victoria Embankment, London, E. C. 2, Eng.

(The) Accountant (Eng.), 4 Drapers' Gardens, Throgmorton Ave., London, E. C. 2, Eng.

(The) Accountants' Magazine (Scot.), 27 Queen St., Edinburgh 2, Scot.

Accounting Research (Eng.), Cambridge University Press, Bentley House, 200 Euston Road, London N.W. 1, Eng.

Accounting Review, College of Commerce and Administration, Ohio State University, Columbus 10, O.

(The) Chartered Accountant in Australia, c/o The Institute of Chartered Accountants in Australia, Box 3921 by P.O. Sydney N.S.W., Australia

Cost and Management, 31 Walnut St. S., Hamilton, Ont.

(The) Economic Club of Detroit, 920 Detroit Free Press Bldg., 321 Lafayette Ave., Detroit 26, Mich.

(The) Federal Accountant, 1523 L St. N.W., Washington, D.C.

Internal Auditor, 120 Wall St., New York 5, N.Y.

Journal of Accountancy, 270 Madison Ave., New York 16, N.Y.

Michigan Business Review, School of Business Administration, University of Michigan, Ann Arbor, Mich.

Municipal Finance, 1313 E. 60th St., Chicago 37, Ill.

N.A.A. Bulletin, 505 Park Ave., New York 22, N.Y.

BY J. E. SMYTH, F.C.A.

Students Department

Associate Professor, Queen's University

PUZZLE

Dicksee, Hatfield, Montgomery, Spicer, and Pegler sit for their examinations. Their final standings are in that order.

Marks are awarded as follows: the candidates each take five subjects—English, Accounting, Auditing, Economics, and Law. The candidate placed first in a subject scores five marks; the candidate who is second, four marks; the third candidate, three marks, and so on. Final standings depend on the aggregate marks scored.

Dicksee – a good examinee – scores 24 marks in all. Montgomery scores the same mark in each of four subjects. Pegler is top in Economics and third in Law.

What mark does Hatfield score in Economics?

(Submitted by a reader in Port Credit, Ontario.)

The solution to the above puzzle appears at the end of the "Problems and Solutions" in this issue.

PROBLEMS AND SOLUTIONS

Solutions presented in this section are prepared by qualified accountants, and reflect the personal views and opinions of the various contributors. They are designed not as models for submission to the examiner but rather as such discussion and explanation of the problems as will make their study of benefit to the student. Discussion of solutions presented is cordially invited.

PROBLEM 1

Final Examination, October 1956

Accounting III, Question 1 (15 marks)

CA, the shareholders' auditor, of Y Co. Ltd. receives the following letter from its secretary-treasurer:

Dear Sir:

As you know, the M Appraisers have recently completed an appraisal of the fixed assets of our company. The directors are most anxious to have the accounts adjusted to reflect this new valuation of the fixed assets. Since we have had no experience along these lines we would appreciate your advice concerning the statement presentation and accounting treatment of the credit arising from the recording of the appraisal valuation.

We have the following questions to ask:

(i) In what section of the year end balance sheet should the appraisal increase credit be shown? Why?

(ii) How should this credit be described? Why?

(iii) What is your opinion of the following alternative suggestions made by the directors as to the write-off of the appraisal increase credit:

(1) Annual depreciation charged against earnings is to be based on cost as previously recorded. The appraisal increase credit is to be written off by annual transfers to "Accumulated depreciation" in the amount of the excess of current depreciation provision on appraisal value over amount taken into profit and loss.

(2) Annual depreciation charged against earnings is to be based on appraisal valuation. The appraisal increase credit is to be written off by annual transfers to "Earned surplus" in the amount of the excess of this provision over what it would have been had depreciation been calculated on the basis of cost as previously recorded.

(iv) Do you consider the recording of appraisal valuation to be in conformity with good accounting principles? If so, why? If not, why not?

Your immediate attention to this enquiry would be appreciated and we thank you in advance for your kind cooperation.

Yours truly,
Secretary-Treasurer.

Required:

The letter of reply which CA should send to the secretary-treasurer, having regard to the recommendations of the bulletins of the Canadian Institute of Chartered Accountants.

A SOLUTION

Mr. A. B. Brown,
Secretary-Treasurer, Y Co. Ltd.,
Toronto.

Dear Mr. Brown:

We have your letter of October 24 requesting our opinion about the appropriate statement presentation and accounting treatment of the revised valuation of fixed assets resulting from their recent appraisal.

If the appraisal increase credit is to be recorded in the accounts, it should be presented on the balance sheet as a separate item in the shareholders' equity section. Incorporating the appraisal figures in the accounts is a restatement of the company's assets which does not affect the liabilities of the company. It amounts, therefore, to a restatement of the shareholders' interest in the total assets. It is important that the appraisal increase credit be shown as a separate part of shareholders' equity because it measures an unrealized increase in value.

We suggest that the appraisal increase credit be described on the balance sheet as "Excess of appraised value of fixed assets over cost". In this way it may be clearly distinguished from retained earnings or other types of surplus. We think that terms such as "appraisal surplus" or "appraisal reserve" should be avoided because they tend to confuse the item with realized parts of shareholders' equity.

It is generally accepted accounting practice that when appreciation of fixed asset value has been recorded on the books, income should be measured in terms of depreciation computed on the appraised fixed asset figures. The basic relationship between its balance sheet and income statement is seriously impaired if a company claims an increased property valuation in its balance sheet and reports only the amortization of a smaller amount in its income statement. We think, therefore, that the first of the alternative suggestions made by the directors as to the write-off of the appraisal increase credit is not satisfactory.

The second alternative would, in our opinion, be an acceptable treatment. Research Bulletin No. 11 of the Canadian Institute of Chartered Accountants expresses the opinion that once the appraisal increase has been recorded it may remain indefinitely as a separate item of shareholders' equity or it may be written off as suggested in your second alternative.

Fixed assets are normally accounted for on the basis of their historical cost, and for this reason the recording of an appraisal valuation may be said not to be in conformity with good accounting principles. Rather than make entries in the books to reflect the appraisal, it is generally preferable to disclose the appraisal figures in a note to the balance sheet. Exceptional circumstances may, however, justify incorporating the appraisal in the books, as where an appraisal is confirmed by the purchase price paid for a controlling interest in a subsidiary, or in a reorganization in which the relative interests of bondholders and shareholders should be re-defined.

If we may be of further assistance to you, please do not hesitate to write again.

C.A.

Editor's Comments

Bulletin No. 11 of the C.I.C.A. Committee on Accounting and Auditing Research includes the following recommendations affecting appraisal increases:

" . . . the committee believes that the word surplus should be restricted in its use to amounts which have been realized, and should not be used, as it has been on occasion in the past, to describe unrealized increases in the value of fixed assets. In the view of the committee the designation of any such amount as an appraisal surplus or reserve is undesirable. One suitable designation for an appraisal increase would be 'Excess of appraised value of fixed assets over cost' (or 'over depreciated cost').

"Fixed assets are normally accounted for on the basis of their historical cost and in recent years accounting organizations have re-affirmed the emphasis on historical cost by refusing to recommend depreciation on current replacement cost in formal accounts. Unless replacement cost accounting becomes generally acceptable, the writing up of fixed asset values should not occur in ordinary circumstances and should be discouraged. It is recognized that there may be exceptions in instances where the appraisal is confirmed by an actual purchase and sale (as in the acquisition of a subsidiary) or in a

reorganization, or where a substantial issue of securities, especially equity shares, is being made. If the appraisal is recorded, subsequent charges against income for depreciation should be based on the new values.

"Once recorded the appraisal increase may remain indefinitely as a separate item in the shareholders' equity section of the balance sheet, or it may be transferred to earned surplus in amounts not exceeding the realization of appreciation through sale or annual depreciation provisions."

The Committee on Accounting Procedure of the American Institute of Certified Public Accountants has expressed the following opinion on this problem in its Bulletin No. 43, Chapter 9, section B:

"Historically, fixed assets have been accounted for on the basis of cost. However, fixed assets in the past have occasionally been written up to appraised values because of rapid rises in prices levels, to adjust costs in the case of bargain purchases, etc. In some of these instances companies have continued to compute depreciation on the basis of cost.

"When appreciation has been entered on the books income should be charged with depreciation computed on the written-up amounts. A company should not at the same time claim larger property valuations in its statement of assets and provide for the amortization of only smaller amounts in its statement of income. When a company has made representations as to an increased valuation of plant, depreciation accounting and periodic income determination thereafter should be based on such higher amounts."

It is of interest that three members of the American Institute Committee assented with the qualification that the appraisal credit should in their view be treated as permanent capital and would therefore not be available to subsequent transfer to earned surplus as realized through depreciation or sale.

PROBLEM 2

Final Examination, October 1956

Auditing II, Question 3 (15 marks)

Frequently, on the completion of an audit engagement, the auditor prepares a report to the directors and management of the concern as well as a report to the shareholders. The former report should be designed primarily to present and interpret information which may contribute to the efficient management of a concern.

Required:

Outline the information, statements and schedules which should ordinarily be included in the auditor's report to directors and management, and explain, in each case, the reason for their inclusion.

A SOLUTION

Contents of Auditor's Report to Directors and Management

1. The report should begin with a brief statement of changes during the past year which are significant for an interpretation of the company's financial statements and for a comparison of its results of opertions with those of previous years. Such changes would include additional financing and the introduction of new products.

2. A condensed statement of profit and loss in comparative form setting out the dollar increases or decreases in the various items and expressing, for both the current and preceding year, the amounts of these items as a percentage of sales of the corresponding year. The purposes of this statement are to indicate the respects in which the operations of the company may have improved and to bring to light any expenses to which management should pay particular attention in the future. The statement may also give some indication of the effects of new policies introduced during the year.
3. A condensed comparative balance sheet showing the dollar changes in the various items and a schedule of balance sheet ratios as at the current year-end and as at the previous year-end. Comparative figures for the current ratio, the inventory turnover ratio and the collection ratio, for example, will show changes in the financial position of the company and the effectiveness of its purchasing and collection policies, respectively.
4. A statement of source and application of funds. The purpose of this statement is to explain the change in working capital as between the current year-end and the preceding year-end.
5. Summaries showing the composition of the principal items of assets and liabilities in support of the total figures shown on the balance sheet, and indicating in greater detail the methods of valuation used in determining the balance sheet figures. These summaries should include:
   a) An analysis of accounts receivable classified as to the length of time the balances have been outstanding, to assist management in determining whether the company's collection policy has been effective.
   b) A summary of the various types of inventory showing their bases of valuation and the estimated length of time required to use the inventory, as an indication of the efficiency of the company's merchandising policy.
   c) Summaries of the increases and decreases during the year in the classes of fixed assets, in long-term indebtedness and in capital stock.
6. A report on the existing system of internal control, its effectiveness, its weaknesses, and recommendations for its improvement. The report may describe certain methods of procedure which would accomplish the desired end more efficiently.
7. A review of the insurance coverage of the assets, of the main factors in the company's tax position, and recommendations for improvements in accounting and statistical records and in duties of personnel.

PROBLEM 3

Final Examination, October 1956

Auditing II, Question 4 (15 marks)

The comptroller of M Co. Ltd., incorporated under the Companies Act (Canada), has prepared the following statement of earned surplus for inclusion in the company's annual report:

M. CO. LTD.

STATEMENT OF EARNED SURPLUS
for the year ended December 31, 1955

Balance, December 31, 1954		$2,905,000	
Amount transferred to undistributed income as set out below		2,300,000	$ 605,000
Net profit for the year			117,600
			$ 722,600
Deduct:			
Cash dividends:			
Common	$16,000		
Preferred class "A"	18,000	$ 34,000	
Transfer to capital surplus under requirements of Section 61 of the Companies Act (Canada)		75,312	109,312
Balance, December 31, 1955 (excluding tax-paid portion shown below)			$ 613,288
Tax-paid undistributed income:			
Amount transferred as above		$2,300,000	
Deduct:			
Tax paid thereon under Section 105 of Income Tax Act	$345,000		
Stock dividends paid in class "B" preferred shares	75,312	420,312	1,879,688
Balance, December 31, 1955			$2,492,976

During the year, the company paid the 15% tax on undistributed income on hand as at December 31, 1949. The first distribution of this tax-paid undistributed income was made in October 1955, when 75,312 class "B" shares were issued and redeemed. 3,000,000 class "B" preferred shares had been created earlier in the year for this specific purpose, following the authority granted at a special meeting of the shareholders.

Required:

Outline the procedures which CA, the shareholders' auditor of many years standing, should undertake in order to form an opinion on the balance "Earned surplus" appearing on the balance sheet as at December 31, 1955. You are to assume that CA has already satisfied himself as to the accuracy of the figure for the net profit earned on current operations.

A SOLUTION

Auditing Procedures – Earned Surplus as at December 31, 1955

1. Verify that balance at December 31, 1954 is in agreement with the amount shown on the company's balance sheet as at that date. Check the net profit for the year forward from profit and loss account.
2. Verify the transfer to tax-paid undistributed income by (i) ascertaining that it has been authorized by the directors in a resolution confirming the company's election under section 105 of the Income Tax Act and (ii)

checking the calculation of the amount to determine that it comprises assessed taxable incomes of the company from 1917 to the year-end in 1949.

3. Verify the cash dividends reported in the statement of surplus as follows:
   a) Check directors' minutes to determine that their declaration and payment has been authorized.
   b) Determine that the dividends were paid on the number of shares outstanding at the date of record; multiply the rate or amount per share times the outstanding capital stock for both the common and preferred stock.
   c) Examine the cancelled dividend cheques to reconcile total cheques issued with reported cash dividends, and test the dividend cheques to the stock records as to name and amount.
4. Verify the stock dividend reported in the statement of surplus as follows:
   a) Check directors' minutes to determine that its declaration was authorized. Determine that the stock dividend has been issued to common shareholders in the ratio specified in the directors' resolution.
   b) Check the issue of the shares represented by the stock dividend.
5. Verify that the redemption of preferred shares was in accordance with the terms of the preferred shares as set out in the letters patent or supplementary letters patent or awarded to the preferred shares by by-law properly sanctioned and approved by the shareholders. Check that the total of the cancelled "B" Preferred stock certificates agrees with the amount transferred to capital surplus.
6. Examine receipts for 15% tax paid, and check the assessments received from the Income Tax Department. Recommend that in the statement of earned surplus the analysis of tax-paid undistributed income show the number of shares issued as a stock dividend as well as the dollar amount of the stock dividend.

SOLUTION TO PUZZLE

There are 75 marks available in all.

1. Dicksee scores 24 (5, 5, 5, 5, 4). The only possible marks for the other candidates are:

Hatfield	15
Montgomery	13
Spicer	12
Pegler	11 (5, 3, 1, 1, 1).

2. Now Pegler scores 5 marks in Economics.
   Therefore Dicksee scores 4 marks in Economics (the only subject in which he did not obtain top marks)
3. Montgomery's marks must be 3, 3, 3, 3, 1 and the 1 must be in Law (in which Pegler scored a 3)
   Hence Montgomery scores a 3 in Economics.
4. Spicer's marks must be 4, 2, 2, 2, 2, (since all 3's and 4 1's are accounted for). His mark of 4 cannot be in Economics because that is Dicksee's mark.
   Therefore Spicer scores a 2 in Economics.
5. It follows that *Hatfield scores a 1 in Economics.*

NEWS OF OUR MEMBERS

Alberta

Lucas, Baziuk, Thomson & Co., Chartered Accountants, announce the removal of their office to 10022 109th St., Edmonton.

Smith & Weiers, Chartered Accountants, and A. P. Gardner & Co., Chartered Accountants, announce the merger of their respective Prairie practices and the removal of their Edmonton offices to 207-9 Petroleum Bldg., Edmonton. The practice will henceforth be conducted under the firm name of A. P. Gardner & Co., Chartered Accountants, with offices in Edmonton, Vancouver, Terrace, Kitimat and Prince George.

British Columbia

James E. Paterson, C.A. announces the removal of his office to 20 Toronto General Trust Bldg., 520 Seymour St., Vancouver 2.

McDonald, Currie & Co., Cooper Brothers & Co. and Coopers & Lybrand, Chartered Accountants, announce the change of address of their Vancouver office to Canadian Bank of Commerce Bldg., 640 W. Hastings St., Vancouver 2.

W. L. Peaker, C.A. announces the establishment of an office for the practice of his profession at Evans Loop, Penticton.

Roy G. Bell, C.A. announces the removal of his office to 423 West Broadway, Vancouver 10.

Walter L. Turnbull, C.A. announces the removal of his office to Rm. 203, 717 W. Pender St., Vancouver 1.

Leslie S. Scoffham and C. Denis Yeomans announce a change of their firm name from Robertson & Scoffham to Scoffham, Yeomans & Co., Chartered Accountants. They further announce the removal of their office to 1446 Alberni St., Vancouver 5.

Roy A. Shand, C.A. announces the removal of his office to 1815 W. 7th Ave., Vancouver 9.

Prof. Ralph H. Loffmark, C.A. of the University of British Columbia is co-author of a two-volume manual on B.C. company law published recently.

R. J. Forsyth, C.A. has been appointed comptroller of Alberta Meat Co. Ltd., Vancouver.

Manitoba

S. M. Milne & Co., Chartered Accountants, announce the removal of their offices to Ste. 313, Confederation Bldg., 457 Main St., Winnipeg 2.

J. A. Weldon, C.A. has been appointed general campaign chairman of the 1957 drive of the Federation of Catholic Charities, Montreal.

Sharp, Woodley, Scott & McLaughlin, Chartered Accountants, announce the removal of their offices to 620 Royal Bank Bldg., 504 Main St., Winnipeg.

Ontario

Thorne, Mulholland, Howson & McPherson, Chartered Accountants, announce the opening of offices in Winnipeg, Calgary and Vancouver, in addition to their offices presently located in Toronto, Galt and Kitchener.

J. Bowman Boyter, C.A. and Arthur F. Adams, C.A. announce the change in their firm name from J. Bowman Boyter & Co., Chartered Accountants, to Boyter, Adams & Co., Chartered Accountants, with offices at 2281 Yonge St., Toronto.

Clarkson, Gordon & Co., Chartered Accountants, and MacLennan & Co., Chartered Accountants, announce the merger of their practices. The combined practices will be carried on under the firm name of Clarkson, Gordon & Co. with K. Douglas MacLennan as a partner of the firm resident in Windsor.

Fisher, Gordon & Co., Chartered Accountants, announce the removal of their offices to Ste. 403, 67 Richmond St. W., Toronto.

Grossman, Karp & Co., Chartered Accountants, announce the removal of their offices to Ste. 307, 221 Victoria St., Toronto.

John Coleman Sears, Chartered Accountants, announce that the practice of their profession will be carried on under the firm name of Sears, Turk & Co., Chartered Accountants, with offices at 208 King St. W., Toronto.

Millard, Rouse & Rosebrugh, Chartered Accountants, announce the removal of their Simcoe offices to 65 Kent St. S.

P. G. McHardy, C.A. has been appointed treasurer and comptroller of Sparton Air Services Ltd., Toronto.

J. L. Shortly, C.A. has been appointed comptroller of Triarch Corp. Ltd. and Toronto and London Investment Co. Ltd.

Riddell, Stead, Graham & Hutchison, Chartered Accountants, Toronto, announce the admission to partnership of R. Douglas Thomas, C.A.

A. C. Lawson, C.A. has been appointed executive assistant at Babcock-Wilcox and Goldie-McCulloch Ltd., Galt.

Quebec

Riddell, Stead, Graham & Hutchison, Chartered Accountants, Montreal, announce the admission to partnership of M. G. C. Howard, C.A. and P. J. Aird, C.A.

Canadian Thermo Control Co. Ltd., Montreal, announces the appointment of E. J. Wormington, C.A. as treasurer.

H. A. Ladouceur, C.A. is assistant treasurer of Southern Canada Power Co. Ltd., Montreal.

INSTITUTE NOTES

ONTARIO INSTITUTE

Universities Trust Fund: The trustees are pleased to report that 81 firms have contributed $5,400 to the Research Trust Fund. Two grants have been made already, and it is hoped that the university teachers will be applying for further grants in the summer of 1958. B. J. B. Galvin, C.A., of Queen's University has been given a grant to assist in a survey of consolidated financial statement practices in Canada. This project is being undertaken under the Department of Commerce at Queen's, but the Institute grant has enabled Mr. Galvin to broaden the scope of the survey by providing transportation expenses for himself and his assistant. Another grant has been approved for Professor J. E. Smyth, F.C.A., at Queen's to assist him in a project for the National Income Committee of the American Accounting Association.

Coming Events: Presentation of certificates, Friday, February 14, 1958, 3:00 p.m.; 75th anniversary dinner, Friday, March 14, 1958, 7.15 p.m.; 3rd annual conference, Monday, June 16 and Tuesday, June 17, 1958 at the University of Western Ontario, London.

Toronto Discussion Groups: The Practising Members' Discussion Group Committee of Toronto held a panel discussion on "Pensions for the Self Employed" on Thursday, October 31 at 7:30 p.m. Fifty members were present to hear a very interesting panel composed of J. G. Arthur, C.A., Reginald L. Kayler, LL.B., A. H. Mingay, J. Kerr Gibson, C.A. and J. Harvey Perry, Director of the Canadian Tax Foundation.

The next meeting will be held in the C.A. Building, Toronto at 7:30 p.m. on Tuesday, December 3. The subject will be "The Auditor's Responsibility in Respect to Inventories and Inventory Verification". The chairman will be T. A. M. Hutchison, F.C.A., and the panel will include C. L. King, F.C.A., and J. A. Orr, C.A.

Registration 1957: For the year ending October 23, 1957, 399 students were registered as students-in-accounts. They included 287 with high school qualifications, 52 university graduates other than B.Com's and 47 B.Com's or the equivalent; 16 came from other societies. In the previous year the numbers were 404 total, 294 high school, 46 university graduates, 46 B.Com's and 18 from other societies.

Course of Instruction: The Saskatchewan Institute has arranged for the University of Saskatchewan to take over the administration of the C.A. Course of Instruction for their students. The first year is being administered in 1957-58 and the other years will taken over progressively later. This means that the university will arrange for distribution of the course materials and the correction of the students' exercises.

ONTARIO STUDENTS ASSOCIATION

Annual Dance: Top flight entertainment will be a feature of the annual dance of the association to be held Thursday, December 5 at the Palace Pier, Toronto. Benny Louis and his orchestra will provide the music for dancing from 9:00 p.m. to the "wee small hours". Plenty of pre-Christmas fun for all — C.A.'s welcome. Price is a modest $3.00 per couple. Dress informal.

QUEBEC INSTITUTE

On November 8 the Institute held an open house in its assembly hall for students in the final year of English-speaking Montreal high schools. Guest speakers were W. G. Mann, personnel consultant, on "The A.B.C.'s of Career Selection", M. Laird Watt, C.A., former member of the Canadian Davis Cup team, on "What Makes a Winner" and Col. S. H. Dobell, D.S.O., C.A. on "So You Want to be a Businessman". A similar open house for final year students in French high schools is scheduled for Tuesday, December 3 at 4 p.m. The program is under the chairmanship of Andre G. Leroux, C.A.

Supper dance: Members and their guests will swing and sway to the rhythm of Eddie Alexander's orchestra at a formal supper dance on Friday, December 6 in the Rose Room of the Windsor Hotel, Montreal. There will be dancing from 10 p.m. to 2 a.m., with a buffet supper at midnight.

C.A. CLUB OF OTTAWA

The annual meeting of the club took place on October 8 last and the following members were elected to the Executive Committee for the coming year: president, E. D. Lafferty; vice-president, Wm. Hogben; treasurer, M. K. Levinson; secretary, T. E. Brown; members, R. F. Burns, G. W. Dunn, R. B. Humphreys, A. V. Neil, S. G. Payne and B. W. Power.

HAMILTON C.A. ASSOCIATION

On Thursday, October 10, the Hamilton and District Chartered Accountants Association held its first dinner meeting of the season at the Royal Connaught Hotel. Feature of the meeting was a panel discussion on "Estate Planning" by the Estate Planners Council of Hamilton: S. F. Ross of Ross & Robinson, Barristers (chairman); R. A. Evans, Q.C.; A. E. Love of The Royal Trust Company; P. C. Metherell, C.A. of Smith, Metherell & Jackson, Chartered Accountants; R. C. Tomlinson, C.L.U.

SAINT JOHN STUDENTS

The Saint John Branch of the C.A. Students Society of New Brunswick celebrated the end of examinations with a social evening on October 24 at the Renforth Community Club.

MANITOBA STUDENTS

The Fort Garry Hotel was the scene of the 29th annual fall formal of the Chartered Accountants Students' Society of Manitoba which took place at the end of October. Dancing was preceded by a reception and dinner.

QUEBEC STUDENTS

The Quebec Students Society held its annual fall dance in the Sheraton Mount Royal in Montreal on October 25.

CLASSIFIED ADVERTISEMENTS

All replies to box numbers should be sent to The Canadian Chartered Accountant, 69 Bloor Street East, Toronto 5, Ontario

Closing date is 13th of preceding month

CHARTERED ACCOUNTANT age 37, excellent taxation and audit experience seeks position with practising firm of chartered accountants offering prospects of partnership arrangement. Box 719.

CHARTERED ACCOUNTANT, age 35, presently in industry, seeks position with practising firm in Toronto, preferably one with partnership possibilities. Box 725.

CHARTERED ACCOUNTANT age 34, acting supervisor with national firm seeks supervisory position and partnership prospects with medium/large firm in Toronto. Eleven years professional, two years commercial experience. Top references. Box 720.

STUDENTS WANTED: Atlantic Provinces' firm of chartered accountants requires intermediate students. Apply to Box 724.

UNDERGRADUATE OR SENIOR STUDENT required by a new but growing practice, North Toronto. Should be able to drive automobile. An intelligent, thorough and personable applicant will be considered for partnership following graduation. Box 716.

WANTED: Second or third year student by a St. Catharines firm of chartered accountants. Diversified and interesting practice with good opportunity for advancement and partnership possibilities. Box 727.

BOOKKEEPER capable of assuming, in due course, secretary-treasurership of multi-branch company with head office in Montreal. Reply in strictest confidence giving full particulars education, experience, marital status, salary expected, indicating convenience in respect of interview. Box 721.

CHARTERED ACCOUNTANT of partnership calibre. Write stating qualifications and salary expected. Martin K. Levinson & Company, 45 Rideau Street, Ottawa, Ontario.

CHARTERED ACCOUNTANT practising alone with large office at 100 Adelaide St. West, Toronto, wishes to share office, facilities and secretary with other chartered accountants. Box 723.

AUDITOR IV required by Sask. Dept. of Mineral Resources Comp. #5053

Salary Range: $5300 - $6400 per annum. Auditor required to take charge of the audit program for Dept. of Mineral Resources. To conduct complete audits of petroleum and mining company records in Sask. to insure collections of royalties, fees and other levies; applicants require completion of course work for final examinations for Institute of Chartered Accountants and preferably C.A. For further information and application forms, apply to Public Service Commission, Room 328, Legislative Bldg., Regina. Applications should be submitted at an early date for immediate consideration.

WANTED by Jewish B.Com., age 23, who wrote final C.A. examination in October, 1957, and has extensive accounting and system and investigation experience; per diem work in Montreal area for an accounting firm (partnership or succession prospects net prime requirement) or a part-time (i.e. to up three days per week) supervisory position in a business office. Box 726.

ACCOUNTING PRACTICE WANTED: A small or medium sized practice desired in Ontario through direct purchase or association with practitioner contemplating retirement. All replies considered. Box 712.

C.G.A. PRACTICE in Smithers for sale to settle estate. Annual gross $12,000. Details from L. W. Perry, Box 790, Smithers, B.C.

ACCOUNTING PRACTICE WANTED: Small or medium sized practice desired in Winnipeg, through direct purchase or association with practitioner contemplating retirement. Reply Box 717.

PRACTICE WANTED: Established Toronto firm of chartered accountants are interested in acquiring by purchase, amalgamation or succession, public accounting practices anywhere in Ontario. Box 722.

BARRISTERS AND SOLICITORS

McCARTHY & McCARTHY

Barristers and Solicitors

Canada Life Building, 300 University Avenue - Toronto 1, Ont.

WRIGHT & McTAGGART

Barristers and Solicitors

67 Yonge Street - - - - - Toronto 1, Ont.

BEAULIEU, BEAULIEU & CASGRAIN

Barristers and Solicitors

Kent Building, 10 St. James Street West - Montreal 1, Que.

COMMON, HOWARD, CATE, OGILVY, BISHOP & COPE

Barristers and Solicitors

Royal Bank Building - - - - Montreal 1, Que.

DIXON, SENECAL, TURNBULL, MITCHELL, STAIRS, CULVER & KIERANS

Barristers and Solicitors

Bank of Canada Building - Montreal 1, Que.

PHILLIPS, BLOOMFIELD, VINEBERG & GOODMAN

Barristers and Solicitors

464 St. John Street - - - - - Montreal 1, Que.

STIKEMAN & ELLIOTT

Barristers and Solicitors

505 Bank of Canada Building - - Montreal 1, Que.

LIFE INSURANCE